ARRC

Alternative Reference Rates Committee | Newsletter

October – November 2020

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.

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Top 3 Takeaways

1. The ICE Benchmark Administration (IBA), the UK's Financial Conduct Authority (FCA), and U.S. regulators (Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC)) issued announcements about the proposed path forward for the transition away from U.S. Dollar (USD) LIBOR. This was accompanied by an associated statement by the International Swaps and Derivatives Association (ISDA).

These developments as well as details about what they mean for the ARRC's work and next steps for USD LIBOR's endgame are summarized in an ARRC guide. They are also covered in an ISDA webinar (recording and transcript), which brought together leadership from the ARRC, Federal Reserve, Financial Conduct Authority, and ISDA.

- The announcements include supervisory guidance encouraging banks to stop new USD LIBOR issuances as soon as practicable but no later than the end of 2021. They also cite plans to consult on specific timing for ceasing the publication of USD LIBOR, with proposed end dates immediately following the December 31, 2021 publication for the one week and two month USD LIBOR settings, and the June 30, 2023 publication for other USD LIBOR tenors. Together, this would support a smooth transition for legacy contracts by allowing time for most to mature before USD LIBOR is proposed to cease, subject to consultation outcomes.
    - The ARRC applauded this and ARRC Chair Tom Wipf said, *"Today's developments mark exciting headway in moving off of USD LIBOR. They also fully align with the ARRC's efforts, propose a clear path for ending USD LIBOR, and reinforce the importance of the transition to robust reference rates like SOFR… These announcements underscore the importance of our work by shedding more light on how USD LIBOR could conclude."*
- These USD LIBOR developments followed an earlier IBA announcement about consultations on its intention to intention to cease the publication of all GBP, EUR, CHF and JPY LIBOR settings immediately following the LIBOR publication on December 31, 2021.
- Concurrent with that earlier IBA announcement, the FCA laid out transition plans for the coming year, issuing a statement on its "potential approach to the use of proposed new powers under the Financial Services Bill to ensure an orderly wind down of LIBOR" as well as consultations about its proposed policy for using those powers.
- Following these developments regarding USD LIBOR and the other LIBOR currencies, ISDA issued statements (here and here) noting that these announcements do not *"constitute an index cessation event under the IBOR Fallbacks Supplement or the ISDA 2020 IBOR Fallbacks Protocol. Therefore, these statements will not trigger the fallbacks under the supplement or protocol."*
- The IBA also later issued its consultation on its intention to cease the publication of LIBOR settings, noting that it will be open for feedback until January 25, 2021 and IBA *"intends to share the results of the*

consultation with the FCA and to publish a feedback statement summarizing responses from the consultation shortly thereafter."

2. ISDA launched its IBOR (interbank offered rates) Fallbacks Supplement and IBOR Fallbacks Protocol, which will take effect on January 25, 2021.

- The IBOR Fallbacks Supplement amends ISDA's standard definitions for interest rate derivatives to incorporate robust fallbacks for new cleared and non-cleared derivatives that reference the ISDA definitions to address the risk of IBORs becoming unusable. The IBOR Fallbacks Protocol enables market participants to incorporate new fallbacks into their legacy non-cleared derivatives trades.
- The ARRC's Recommended Best Practices encourages market participants to adhere to the Protocol before it takes effect on January 25, 2021. ARRC Chair Tom Wipf noted that *"It is essential that market participants be prepared to adhere to the Protocol to help address both individual firm risks and systemic risks associated with the discontinuation of LIBOR."*
- The ISDA Fallback Protocol has received widespread support from official sector institutions worldwide, with the Financial Stability Board (FSB), the Federal Reserve, the Federal Housing Finance Agency, the Working Group on Sterling Risk Free Rates, the FCA, the Bank of England, the Swiss Financial Market Supervisory Authority (FINMA), the Hong Kong Monetary Authority, the Australian Securities and Investments Commission and the Reserve Bank of Australia encouraging adherence to the Protocol.
- Meanwhile, the Swiss Banking Association published new documentation for the Swiss Master Agreement (SMA) for OTC Derivatives that will facilitate the IBOR transition. By signing the SMA Benchmark Amendment Agreement, counterparties incorporate the Protocol.

3. A further step in the ARRC's Paced Transition Plan was completed when the London Clearing House (LCH) and Chicago Mercantile Exchange (CME) Group successfully transitioned from the Effective Federal Funds Rate (EFFR) to SOFR discounting and Price Alignment Interest (PAI) on all outstanding cleared USD-denominated swap products.

- LCH transitioned over one million cleared contracts (total notional of $120 trillion) from Fed Funds to SOFR discounting and PAI. The transition applied to cleared interest rate swaps across ten currencies, deliverable and non-deliverable forwards and options, and cross-currency swaps.
- Along with LCH, CME successfully executed the SOFR basis swap auction for participants looking for an efficient way to unwind their basis swaps. CME will book offsetting trades in the relevant account of each participant to terminate/close out the Basis Swaps submitted to the auction.
- Based on LCH and CME data, the 'big bang' transition for swaps coincided with a notable increase in SOFR swaps trading. Monthly volume in cleared SOFR swaps trading exceeded $700 billion in October, well in excess of the prior peak of $400 billion set in September.
- The Commodity Futures Trading Commission (CFTC) announced swap transaction and pricing data reporting relief for specific derivatives clearing organizations (DCOs) and market participants participating in DCO auctions to help transition certain cleared swaps from using the EFFR to the SOFR. The relief was announced in two no-action letters including one providing relief for swaps executed as part of the LCH discounting transition and another for swaps executed as part of the CME discounting transition.

Other ARRC Developments

- The ARRC released conventions for using SOFR in arrears—both daily simple SOFR and daily compounded SOFR in Arrears—in bilateral business loans. The ARRC also released FAQs for Business Loans Hardwired Fallback Language. The conventions align with the ARRC's 2020 Objectives and follow the ARRC's revised Hardwired Fallbacks for Bilateral Business Loans.
- The ARRC updated its frequently asked questions (FAQs) to reflect recent developments, information about the work of the ARRC, its progress to date and the overall effort to promote voluntary market adoption of SOFR.

- The ARRC released two sets of FAQs regarding its Requests for Proposals (RFPs) that were published in September 2020. The first FAQ is in regards to the RFP for the Administration of Recommended Spread Adjustments and Spread-Adjusted SOFR Rates to Facilitate Contractual Fallbacks, and the second FAQ is in regards to the RFP for the Publication of Forward-Looking Term SOFR Rates.
- The ARRC agreed to launch a Non-Financial Corporate working group to help significantly raise awareness of the LIBOR transition among the non-financial corporate audience and build their awareness on how to start preparing their organization to adopt SOFR now.
- The ARRC released a memorandum to the Federal Reserve Board, the FDIC and the OCC summarizing its preliminary findings and recommendations regarding potential regulatory considerations associated with the application of current and anticipated capital and liquidity requirements.

U.S. Developments

- The Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) to clarify the scope of FASB's previous reference rate reform guidance issued in March. The amendments in the proposed ASU clarify that certain optional expedients and exceptions for contract modifications and hedge accounting apply to contracts that are affected by the discounting transition. Stakeholders were asked to review and provide input on the proposed ASU by November 13, 2020.
- The Federal Farm Credit Banks Funding Corporation announced the final results of the exchange offer providing holders of their existing LIBOR-linked bonds with an opportunity to exchange these bonds for new LIBOR-linked bonds, which include fallback language based on, but not identical to, the ARRC's recommended fallback language for LIBOR-linked floating rate notes.
- The Internal Revenue Service (IRS) published a Revenue Procedure providing guidance on the transition away from IBORs. The guidance generally provides that modifying contracts to incorporate the ISDA Protocol and ARRC-recommended fallback language will not result in a realization event.
- The Treasury Department, the Federal Reserve Board, the New York Fed, the OCC, the Securities and Exchange Commission, the FDIC, and the CFTC, sent a letter to a number of U.S. regional banks that participated in the Credit Sensitivity Group workshops.
  - The letter noted that *"the official sector does not plan to convene a group to recommend a specific credit-sensitive supplement or rate for use in commercial lending products, but we do plan to bring together workshop participants for two additional working sessions that can highlight the continued innovation in this space, including with regard to various specific credit sensitive rates, and explore solutions to implementation hurdles for commercial loans in the transition away from LIBOR. We recognize that innovation is central to the development and evolution of financial markets, and the official sector supports the continued innovation in, and development of, suitable reference rates, including those that may have credit sensitive elements."*
  - The letter was subsequently followed by a supervisory statement by the Federal Reserve Board, the FDIC, and the OCC about their stance on LIBOR replacement rates specifically for bank loans, reinforcing the agencies' position that it would not endorse a specific replacement rate for LIBOR loans: *"A bank may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs. However, the bank should include fallback language in its lending contracts that provides for use of a robust fallback rate if the initial reference rate is discontinued."*

International Developments

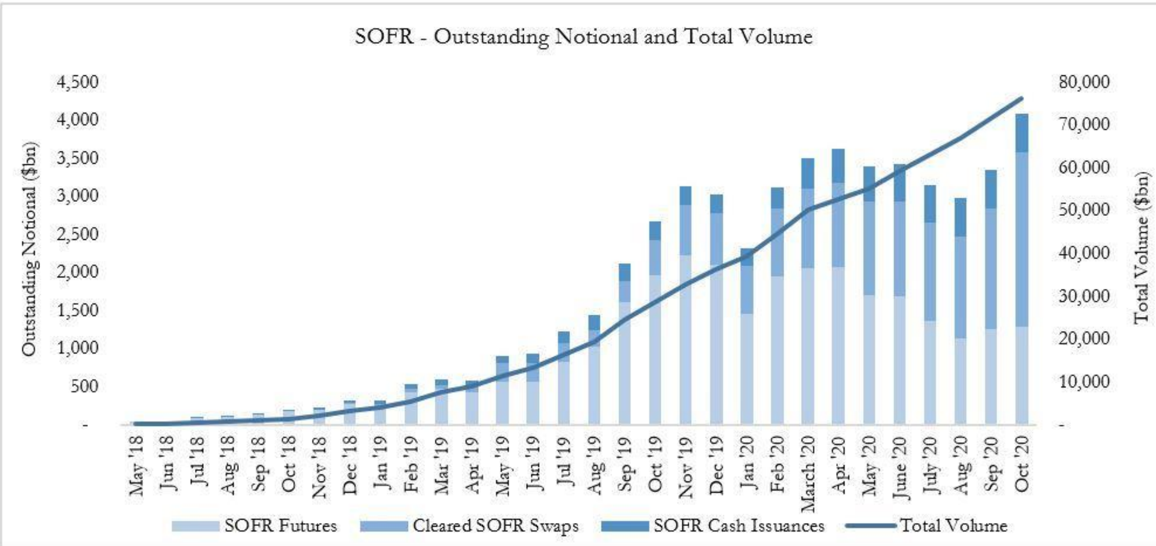
For more details on international efforts for reference rate reform, see the working groups in the U.K., Switzerland, Japan, Hong Kong, the euro area, and the Official Sector Steering Group.

- The FSB issued a backward-looking progress report and a forward-looking roadmap for the transition away from LIBOR worldwide. Specifically:
  - The FSB published a *Global Transition Roadmap for LIBOR*, which sets out a timetable of actions for financial and non-financial sector firms to take to successfully mitigate risks and ensure an orderly transition by end-2021. The steps in the roadmap are intended to supplement existing timelines and milestones from industry working groups and regulators.
  - Later, the FSB published its *2020 Progress Report: Reforming Major Interest Rate Benchmarks*. The report sets out progress on implementing the FSB's recommendations to reform IBORs.

        - Among other findings, the report noted that: work on the transition work needs to accelerate further in early 2021; COVID-19 reinforced the critical importance of reforming global interest rate benchmarks; and all market participants must follow the necessary steps to avoid disruption to the performance of their contracts.
        - Per New York Fed President John Williams and Bank of England Governor Andrew Bailey, who are co-chairs of the Official Sector Steering Group, *"The message that all market participants should take from this Report and yesterday's announcements from the IBA and FCA is that we need to be prepared for the end of LIBOR. Everyone needs to be ready."*
- The European Central Bank (ECB) published a summary of feedback on the public consultation regarding the compounded Euro Short-Term Rate (€STR). The replies came from a broad range of market participants worldwide and were supportive of the main parameters and elements of the backward-looking compounded rate methodology. The feedback and suggestions will be considered when the ECB finalizes the methodology.
- The Working Group on Euro Risk-Free Rates published public consultations on EURIBOR fallback triggers events and EURIBOR fallback rates based on €STR for cash products. The consultations will be open until January 8, 2021.
- The Working Group on Sterling Risk Free Rates published two papers to assist market participants and vendors in staying informed and help them consider whether any amendments may be required to their systems or products:
    - A summary of the freely available independent Risk Free Rate calculators on the market; and,
    - A summary of the key attributes of beta versions of term SONIA rates published by independent benchmark administrators.
- The National Working Group on Swiss Franc Reference Rates published minutes from its September meeting. The group discussed the FINMA self-assessment survey which shows that the Swiss franc LIBOR tough legacy volume appears to be small and not an existential issue. The group also discussed recommendations to use the "shift" methodology and to floor compounded SARON, as long as the domestic market is in the focus. The "lag" methodology and flooring of individual SARON values are viable alternatives for international consistency.
- The Bank for International Settlements published a working paper to show how to optimally determine a term rate known at the beginning of an interest rate period by only using overnight rates.
- The Canadian Fixed Income Forum expanded the mandate of the Canadian Alternative Reference Rate working group to include an analysis of the Canadian Dollar Offered Rate (CDOR). While CDOR has not been subject to the same frailties as LIBOR, there are factors unique to CDOR that have yet to be analyzed in detail.
- The Canadian Overnight Repo Rate Average (CORRA) Advisory Group was established to advise the Bank of Canada's CORRA Oversight Committee on any potential adjustments to the CORRA methodology.
- Supermarket chain Tesco announced that it had established a £2.5bn revolving credit facility, transitioning the facility away from LIBOR with multiple interest periods linked from day one to SONIA and to SOFR for GBP and USD respectively. The three year facility is the first day one Risk Free Rate syndicated loan facility in the UK

SOFR Market Liquidity

- Since SOFR's publication, approximately $820bn notional in floating rate debt instruments tied to SOFR have been issued, with over $500bn outstanding notional at October month-end.



(As of October 31, 2020; Source: CME Group, LCH, 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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