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LIBOR Transition Update: LIBOR Regulators Bow to the Market for the Second Time in a Month

And in the master's chambers
They gathered for the feast
They stab it with their steely knives
But they just can't kill the beast

-*Hotel California* by the Eagles

The Federal Reserve and global regulators gave way to the market for the second time in less than a month with a release on November 30th that outlined their capitulation on the End-of-2021 death of USD LIBOR. The Fed's statement[1] stated, in part (Advocate comments afterwards in italics):

1. "Under the proposal from LIBOR's administrator, ICE Benchmark Administration Limited (IBA) will consult in early December on its intention to cease the publication of the one week and two month USD LIBOR settings immediately following the LIBOR publication on December 31, 2021". *No more 2-month LIBOR?? Whatever shall we do???*
2. "… and the remaining USD LIBOR settings immediately following the LIBOR publication on June 30, 2023". 1m, *3m, 6m and 12m LIBOR are the main market benchmarks so this is the real takeaway in the announcement – an 18-month (for now) extension to the end-of-LIBOR*.
3. "The announcements today by regulators in the United States and United Kingdom and by the benchmark administrator for LIBOR together lay out a path forward in which banks should stop writing new USD LIBOR contracts by the end of 2021, while most legacy contracts will be able to mature before LIBOR stops". *It hasn't worked for the last 3 years, but we're sure this will do the trick, really.*

The UK FCA and the 3 US regulators (Fed, OCC and FDIC) all released their own statements in support of this new June 30, 2023 cessation date. Below are some of our brief thoughts on the Fed statement:

Implication 1: Regulators are (Finally) Acknowledging the Emperor's Lack of Threads

With a year to go before the stated end of LIBOR, US regulators have finally bowed to the inevitable – that the current pace of post-LIBOR RFR adoption in the US is going much, much slower than they had anticipated, and that ramming through an end-of-2021 LIBOR cessation would lead to an unmitigated financial logjam of their own making.

[1] *Federal Reserve Board welcomes and supports release of proposal and supervisory statements that would enable clear end date for U.S. Dollar (USD) LIBOR and promote the safety and soundness of the financial system*. Board of Governors of the Federal Reserve System, November 30, 2020.

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There is ample evidence that the US market is not ready and does not wish to transition to SOFR:

1) **Lack of Readiness**. Bloomberg[2] quoted a Duff & Phelps survey that one-in-five companies surveyed hadn't started *any* transition away from LIBOR, and that two-thirds of those surveyed have not completed *planning* for the change.
2) **No Desire to Use SOFR**. While SOFR derivative activity swelled in October with the forced "Big Bang" swap discounting switch from Fed Funds to SOFR, the dropoff in SOFR activity thereafter has been remarkable.
    a. ISDA monthly swap trading data shows that SOFR volume was about 10% of LIBOR during the month of October when the "Big Bang" occurred
    b. Bloomberg's Gilbert[2] noted that in the week ending November 20th, almost $2.5 Trillion notional of LIBOR swaps were traded, compared to $70.5 Billion of SOFR swaps (less than 3%). Year-to-date in 2020, the notional of SOFR swaps remains only about 2% of LIBOR swaps.

The lack of desire to adopt SOFR in the US stands in sharp contrast with the UK, in which more than half of GBP swaps traded in 2020 were based on SONIA (the regulator-preferred post-LIBOR RFR) rather than STG LIBOR.

Part of the reason for the regulatory delay may also be the recognition that the hardest part of the LIBOR transition is yet to take place. The struggle to move LIBOR swaps into SOFR will be nothing compared to the titanic battle to move bank loans and floating rate notes away from LIBOR. While financial companies have taken to issuing a considerable amount of SOFR floating rate notes, there has been practically no acceptance of SOFR by non-financial issuers and high-yield issuers and investors.

Implication 2: Use the Extra Time Wisely to Find the "Right" LIBOR Successor

In our view, the extra 18 months of LIBOR transition time should not be spent on mindlessly shuffling existing LIBOR exposure into SOFR, but rather on finding the appropriate RFR that suits each user's unique requirements and needs. Earlier in November 2020, regulators belated conceded[3] that banks are free to use non-LIBOR and non-SOFR indexes in their floating rate banking products. Floating rate market participants now have more time to experiment with different floating rate indexes and eventually to gravitate around one or a few. As long as these floating rates are not LIBOR-based, there is now clearly no regulatory edict against their usage.

We include an updated list of possible US floating rate indexes from prior publications and identify the RFRs that contain a bank credit component.

[2] "Libor's Likely Reprieve Is Welcome Nod to Reality", Bloomberg Opinion article by Mark Gilbert, November 30, 2020.
[3] *Statement on Reference Rates for Loans*. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, November 6, 2020

FIGURE 1. SOME ALTERNATIVE US "RISK FREE RATES" (RFRS)

Alternative RFRs	Available Maturities	Has Bank Credit Spread?	RFR Liquidity	Comment
Fed Funds	O/N	Y	Excellent	Daily trading volume between $30-$80Bn. Highest liquidity basis swap instrument in the market today.
Prime	O/N	Y	Good	Primarily used by middle-market corporations. Historically FF+300bps, now 300-325bps given FF target range.
OBFR (Overnight Bank Funding Rate)	O/N	Y	Excellent	High daily transactions ($100-200Bn).
T-Bill	4-, 8-, 13- , 26-wk, 1yr	N	Excellent	Excellent liquidity and transparency due to frequent and highly transparent auctions overseen by the US Treasury Department. Lower secondary trading volume and liquidity.
Ameribor	O/N, 30-day, 90-day	Y	Very Good	Banking funding rate based on daily volume-weighted US bank funding transactions (not poll).
COFI (Cost of Funds Index, Various Districts)	1m (in arrears)	Y	Low	
Commercial Paper (Top Tier)	1-, 7-, 15-30-, 60- and 90-day	Y	Excellent	Index publication and methodology has been overseen by the Fed since the 1990's.
CMT (Constant Maturity Treasury)	2y, 3y, 5y, 7y, 10y, 20y, 30y	N	Excellent	Treasuries notes and bonds are the very definition of market liquidity.

Sources: Bloomberg, Federal Reserve, US Treasury Department, Advocate

Implication 3. Craft, Adopt and Implement A Coherent Floating Rate Strategy During the Extra 18 Months of Transition Time

The extension of the end-of-LIBOR timeline gives floating rate market participants extra time to sample the various flavors of RFRs (with and without a credit risk component) to plot the best path forward. It remains critical that borrowers work with their finance staff and external advisors to craft, adopt and implement a well-considered approach to the end of LIBOR that fits their unique profiles. As the usage of non-SOFR RFRs has effectively been given the official regulatory green light, a coherent funding-mix strategy that allows for a diverse and customized set of floating rates in conjunction with the prudent use of derivative hedges will be critical to meeting the challenges arising from the end-of-LIBOR.

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