Credit/Rates Strategy

LIBOR-SOFR unlikely COVID-19 immune

17 April 2020

Credit/Rates Strategy
United States

COVID-19 likely to impact timing of LIBOR demise

The world has changed dramatically in the past 2 months due the COVID-19 pandemic. The global spread of the virus has forced human interaction and business practices to fundamentally change in a very short period of time. However, there is one major global financial initiative that appears on the surface to be immune to COVID-19: the global LIBOR transition. We are skeptical the global LIBOR transition remains immune from the virus and see increasing risks the end '21 deadline is extended.

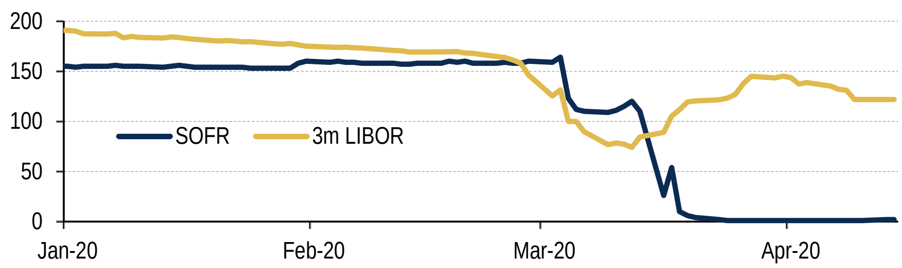
In the US, we see risks the transition is extended due to: (1) more pressing business needs in the current environment (2) a warming but still tepid embrace of SOFR in financial derivatives, debt, & loans (3) slower progress on finding a credit sensitive alternative to LIBOR. We believe the recent divergence between USD LIBOR & SOFR has strengthened the desire for lenders to retain a benchmark with dynamic credit sensitivity (Chart 1). However, COVID-19 disruptions have likely delayed some of the "credit sensitivity" workshops between US regional banks & US authorities.

Recent market stress has also seen a decrease in underlying 3m bank funding activity, especially in late March. This drop off in activity reminds of the challenges associated with finding a robust credit sensitive benchmark. Any credit sensitive alternative (1) must remain robust to underlying market stress, possibly via a commitment from banks to continue issuing in stressed times (2) may need to expand beyond banks.

LIBOR transition extension risk increasing

We would not be surprised to see the USD LIBOR to SOFR transition extended a number of months or quarters, even though the official sector has continued to resist this possibility. The continued insistence on transitioning away from by end '21 risks criticism that it is diverting resources away from more pressing business objectives and may appear out of touch with existing macroeconomic realities. A delay in the USD LIBOR transition would likely allow the market to more deeply explore options around a dynamic credit-sensitive alternative, including those robust to periods of acute market stress.

Chart 1: LIBOR and SOFR have diverged as the Fed cut rates (bps)



Source: Bloomberg

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SOFR: Secured Overnight Financing Rate

Official sector guidance on LIBOR transition unchanged

Official sector guidance on the ultimate global LIBOR transition deadline has held firm at the end of '21, although it has been acknowledged that some interim deadlines will be missed. The UK Financial Conduct Authority (FCA) is the most relevant authority to watch since they have ultimate jurisdiction over the global LIBOR transition. Below is the extent of official sector guidance on the LIBOR transition deadline:

UK Financial Conduct Authority (FCA): the UK FCA has provided the most concrete guidance on the broad LIBOR transition, which has suggested that end '21 should remain the target date though some interim milestones may be missed. Specific FCA guidance from March 25:

> *"The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet… There has, however, been an impact on the timing of some aspects of the transition programmes of many firms… [International authorities] will continue to monitor and assess the impact on transition timelines, and will update the market as soon as possible."*

The FCA's position on the LIBOR transition deadline was recently strengthened with the ISDA communication on pre-cessation fallbacks. ISDA announced that a significant majority of market participants are in favor of including both pre-cessation fallbacks as standard language in the amended 2006 ISDA Definitions for LIBOR contracts. This will allow for the FCA's determination of LIBOR "non-representativeness" to trigger swaps to move off of LIBOR and to the preferred fallback rates. It increases the impact of the FCA's judgment in making a determination for the effective end of LIBOR.

Overall, it seems the FCA remains committed to the end '21 deadline but did suggest they are monitoring the impact on various deadlines to see if additional flexibility is needed. It is possible the UK FCA's focus on the end '21 deadline may be reflective of a focus around market regulation. We might expect more flexibility on the timing of LIBOR transition from the Fed & other central banks that consider macroeconomic stability.

Alternative Reference Rate Committee (ARRC): the Fed sponsored ARRC has not provided as explicit of guidance as the FCA but recent communications suggest limited flexibility around key deadlines. The most recent ARRC minutes from March 20 reflect that "it is important to preserve the momentum behind the ARRC's work despite evolving circumstances, particularly given that there has been no change to the existing timeline for the LIBOR transition." However, the ARRC legal group has acknowledged that the "legislative solution" amending New York state law to allow for a clearer LIBOR cessation fallback in certain financial contracts may be impacted due to challenges with the New York State Legislative session.

The ARRC appears committed to press ahead with existing deadlines even though some of their preferred fallback solutions appear challenged by COVID-19 disruptions.

Credit Sensitivity Group Workshops (CSG): US regulators also committed in February to discuss ways to support the transition of loans away from LIBOR. These included holding a series of working sessions to "explore methodologies to develop a robust lending framework that considers a credit sensitive rate element in the lending markets as a supplement to SOFR" (see here for a discussion of credit sensitive alternatives to SOFR). The discussions were slated to "be completed in the spring of 2020". However, there has been no public communication on any CSG workshops or public guidance on the timing of upcoming meetings / workshop minutes.

Federal Housing Finance Agency (FHFA) Guidance: FHFA has laid out a number of deadlines for the Federal Home Loan Banks (FHLBs) and Fannie / Freddie to transition away from LIBOR. While most of these deadlines have been held, FHFA did provide flexibility on the timing around which the FHLBs need to cease entering into LIBOR based contracts that mature after Dec 31 '21. In mid-March FHFA extended this deadline from March 31 '20 to June 30 '20. We suspect FHFA granted this exemption due to operational issues + complications around COVID-19.

Main takeaway: end '21 remains surprisingly firm despite slipping deadlines
On the surface, regulators remain committed to the end '21 LIBOR transition deadline while acknowledging that interim deadlines are slipping. The end '21 deadline appears unchanged while working groups set to explore other credit-sensitive alternatives to SOFR have lost valuable time that they may be unable to recover.

We also find it striking that regulators still remain firm on the end '21 deadline in light of: (1) Fed relief measures that rely heavily on commercial banks, which will divert attention elsewhere (2) regulatory flexibility in other supervisory areas (3) potential bank willingness to provide LIBOR beyond end '21. A few thoughts on each:

- Fed COVID-19 relief measures have relied heavily on commercial bank participation, including the Paycheck Protection Program & Main Street Lending Facility. We expect that many banks have had to devote increasing resources to staffing these programs and fewer resources to the LIBOR transition.

- The Fed and other official agencies have shown increased regulatory flexibility around SLR, CECL, & capital relief for MMLF + PPP loans. Given that some regulatory mountains have been moved we would think it is possible the LIBOR transition deadlines could also be considered.

- At end '21 USD LIBOR *may* cease to exist but it also *may not* cease to exist. Some panel banks have indicated an intention to stop providing USD LIBOR submissions at end '21 but we don't know how many banks will remain willing providers. We suspect there may be enough USD LIBOR panel banks to continue a publication at 1- & 3-month tenors for a time. We also believe that the UK FCA determination of LIBOR "representativeness" is subjective and could be flexible to accommodate recent COVID-related disruptions.

If the official sector was willing to extend the LIBOR transition it would likely be useful to: (1) provide the FCA with more authority to compel LIBOR panel bank submissions (2) receive a firm commitment from enough banks to provide submissions for an extended period of time (3) loosen the relatively arbitrary assessment of LIBOR submission "representativeness", which the FCA has previously indicated could be breached if only one LIBOR panel bank ceased providing submissions.

COVID-19 has already changed the world dramatically and official sector actors have taken swift and meaningful action to ease its challenges. The LIBOR transition seems one area where there has been a lack of movement in the official sector thus far.

Warming but still tepid embrace of SOFR in markets

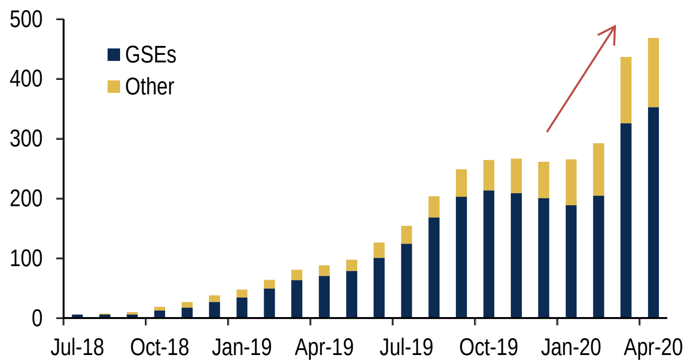
COVID-19 would offer a clear justification in our view if regulator wanted to be more flexible around the LIBOR transition deadline. The still tepid embrace of SOFR across markets further strengthens this case. The market appears to be slowly warming towards adopting SOFR in futures and derivatives but has yet to embrace SOFR in loan contracts. We update SOFR usage across markets below.

Financial markets SOFR adoption
Issuance: in recent weeks SOFR market activity has increased, with a spike in SOFR issuance driven by higher cost of funding via LIBOR. The more attractive funding levels have likely led the FHLBs to use SOFR floaters for their increased member financing needs in the recent period of financial stress. Together, all GSEs issued $140bn in SOFR linked debt in March and the GSEs remain the largest user of SOFR-linked floating rate debt. We expect to see heavy GSE issuance in coming months if LIBOR remains relatively elevated (Chart 2, Chart 3, Chart 4).

Futures: SOFR futures activity declined around year end, but has since returned to levels seen in November & December (Chart 5, Chart 6). Despite the recent increase in activity, SOFR open interest remain only at 30% of the fed funds markets and less than 5% of the Eurodollar market.

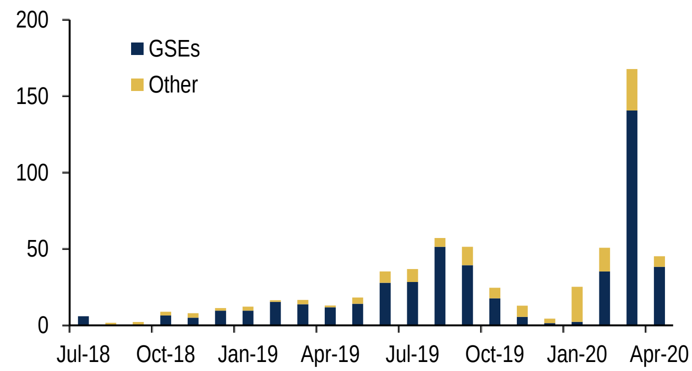
Swaps & swaptions: SOFR swap activity continues to gradually increase but there has been no material SOFR swaptions activity to date (Chart 7). Within the swaptions space, the most significant recent development on SOFR transition was an ISDA supplement from late March and allowance for an adoption of SOFR as a discount rate in swaption contracts with expiry date after the CCP transition date (Oct 16). The potential for a SOFR discount rate in existing contracts does not seem to have led to a material shift in hedging behavior.

Chart 2: SOFR linked debt outstanding ($bn, as of Apr 13)



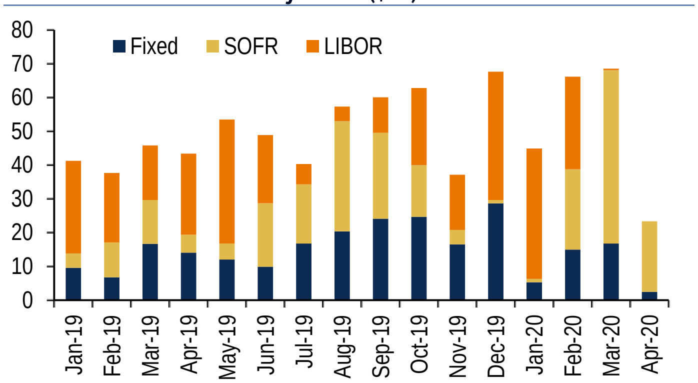
Source: Bloomberg; Note: GSEs include FHLBs, Fannie Mae, Freddie Mac, Farmer Mac, Federal Farm Credit Bank

Chart 3: SOFR linked FRN debt issuance by month ($bn, as of Apr 13)



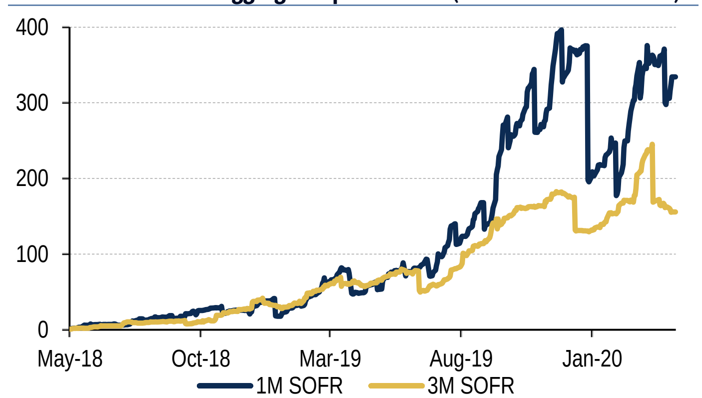
Source: Bloomberg; Note: GSEs include FHLBs, Fannie Mae, Freddie Mac, Farmer Mac, Federal Farm Credit Bank

Chart 4: FHLB debt issuance by month ($bn)



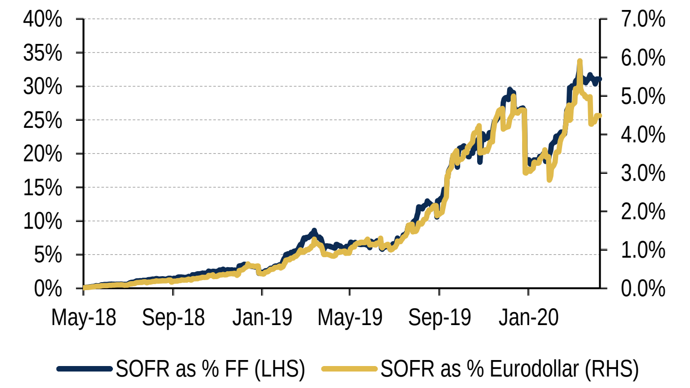
Source: Bloomberg

Chart 5: SOFR futures aggregate open interest (thousands of contracts)



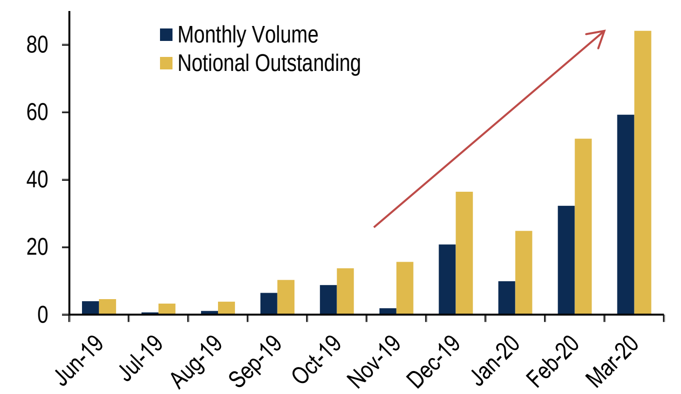
Source: Bloomberg, CME

Chart 6: Total SOFR open interest as % of FF & ED futures



Source: Bloomberg, CME

Chart 7: CME cleared SOFR swap activity ($bn)



Source: CME

Loan market SOFR adoption

SOFR linked activity in the corporate loan market continues to be limited. While some bilateral bank loans have been priced off of the new benchmark, take up of the rate has been extremely low in the broadly syndicated and private lending markets. The loan market was already facing challenges in the LIBOR transition before the current downturn. Now with deterioration of economic activity, corporate priorities lie elsewhere. As companies rush to shore up their balance sheets and adapt operations to a new reality, transitioning to a new benchmark rate seems to have receded into the background. In our opinion, it seems likely that we will need to return to healthier markets, and likely a push from the Fed for this issue to become a C-suite priority.

We are skeptical that the inclusion of SOFR as the benchmark for the Fed's Main Street Lending Facility will materially increase adoption of the new benchmark unless terms of the program are adjusted. Recall, the Main Street Lending Facility offers loans to small/medium sized businesses off of SOFR. To the extent that the Main Street facility does well, it could help increase the amount of SOFR-linked assets on bank balance sheets. However, after further analysis, we believe the utilization of these facilities is likely to be limited, as it's not evident who the target audience of this program is. 90% of the current loan issuers don't pass the stringent eligibility criteria set out by the facilities, while the program for new issuers, with its small loan sizes, is limited in scope.

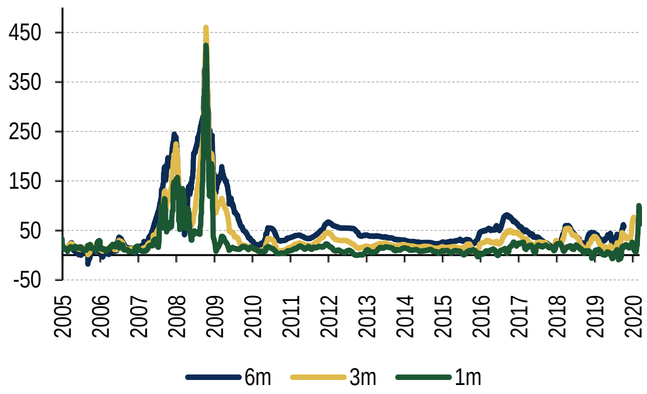
Further, the economics of Main Street loans make it worthwhile to only be used as a lifeline of the last resort. We expect that issuers in dire need of funds will likely come wider than the 250-400bps range set out by the facilities. We also question the willingness of banks to take a stake, however small, in challenged situations. While the program is still in the comment phase and may be adapted to better fit needs of more borrowers, we think that the introduction of these facilities will only help SOFR adoption on the margin, likely in the bilateral bank loan market to the extent banks want to maintain some prized corporate relationships. We doubt this push is enough to jump start a broader SOFR wave in the broadly syndicated and private loan markets.

LIBOR move boosts case for credit sensitive alternative

USD LIBOR & SOFR have behaved very differently over recent weeks due to market liquidity deterioration, Fed balance sheet / reserve expansion, & increased perceptions of credit risk (Chart 1). The historic spread between USD LIBOR & compounded SOFR reached the widest levels since the '08 financial crisis; this has been a benefit to lenders that make floating rate LIBOR loans while serving as a cost to floating rate LIBOR borrowers. We expect the recent divergence between LIBOR & SOFR to further advocacy for a dynamic credit sensitive alternative to cushion bank lender NIM deterioration during credit events. The recent divergence between LIBOR & SOFR has already caused a modest increase in ISDA fallback levels, assuming USD LIBOR ceases at end '21 (Table 1).

Chart 8: Historical SOFR-LIBOR spread (bps)

SOFR compounded in arrears, historical SOFR uses PD survey GC repo rate



Note: NY Fed primary dealer GC repo rate used prior to SOFR data availability; source: BofA Global Research, Bloomberg

Table 1: 5y median SOFR-LIBOR spread (bps)

SOFR compounded in arrears, historical SOFR uses PD survey GC repo rate

	1m	3m	6m
Dec 2021 Lookback	16.4	28.5	42.4
Historical Data Only	10.1	24.7	35.4
Historical Data Only, as of Feb 3	9.5	23.8	33.8

Source: BofA Global Research, Bloomberg

We expect that banks making LIBOR based floating rate loans will see the recent price action as furthering the desire to have a dynamic credit sensitive alternative. These banks will likely not want to forgo the potential protection of having credit sensitive loans in future episodes of severe economic contraction. Loans that would otherwise float off SOFR would have re-priced lower and challenged NIMs for these lenders. Lenders are likely acutely aware of the Fed's desire to push SOFR to near zero while being perfectly content to allow USD LIBOR rates to remain nearly 100bps higher through their control and pricing of money market liquidity facilities.

In contrast to the bank lenders, the Fed probably would like to see floating rate loans priced off of SOFR to provide a more immediate relief to borrowers. We believe this desire is one of the core reasons the Fed has staunchly advocated for and leaned on the ARRC to choose SOFR as the preferred alternative to LIBOR. However, any benefit that a SOFR floating rate loan might receive during times of market stress would likely be made up through higher loan pricing in periods of calm as we argued here.

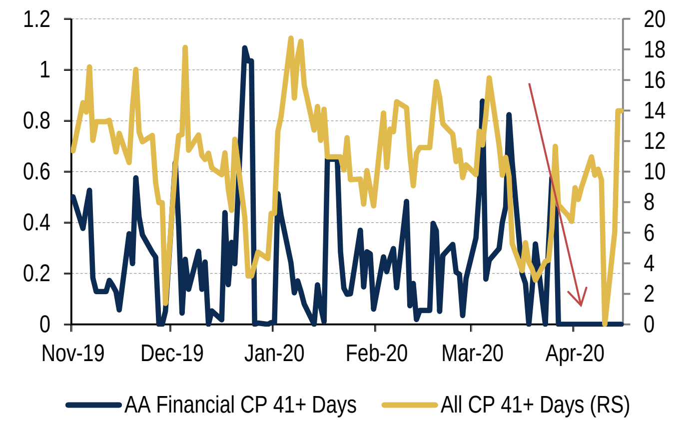
We expect that the desire from bank lenders to have dynamic credit protection will eventually be successful in creating an add-on rate to SOFR or standalone credit sensitive index. Recent price action has likely reinforced the necessity of having this dynamic credit sensitivity and further strengthened the desire for regional banks to work with the Fed on charting a path in this direction. If regional bank CSG workshop progress is materially delayed we expect opposition to the end '21 LIBOR deadline will increase.

Credit sensitive rate needs to be robust in market stress

During recent market stress, 3m unsecured bank activity materially declined. This must be taken into consideration when developing a credit sensitive rate. To ensure robustness during market stress, a credit sensitive index may require a bank commitment to continue issuing at all times or it may need to expand beyond banks.

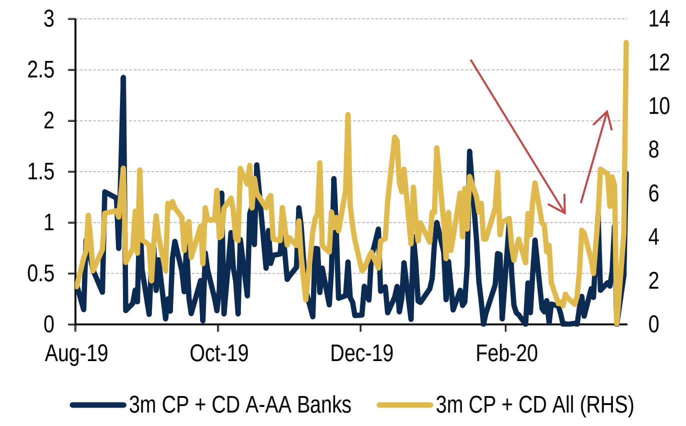
The extent of the drop off in 3m bank funding activity is striking, especially in the second half of March. According to the Fed's AA financial CP data, there was zero issuance activity for tenors of 41+ days from March 27 through today. This stands in contrast to all CP issuance at the same tenor which averaged $9.4bn (Chart 9). Primary + secondary market transactions across 3m A & AA financial CP & CD also declined, according to DTCC. This data shows a decline in bank CP transactions in late March, but a material rebound over recent days. DTCC data also shows more widespread activity across all 3m CP & CD paper (Chart 10).

Chart 9: 41+ AA financial CP issuance has recently fallen off ($bn)



Source: BofA Global Research, Federal Reserve

Chart 10: Some activity in primary + secondary mkt transactions ($bn)



Source: DTCC

The sharp drop in bank funding activity at the 3m tenor highlights issues around the robustness of any credit sensitive index during periods of market stress. A credit sensitive index needs to ensure that it can be informative and reflective of market activity at all times. We believe that improved robustness could be achieved by requiring a commitment from banks that want a dynamic credit sensitive benchmark to issue at a minimum frequency even during stressed times. If banks are unwilling or unable to issue during such periods we think that it is worth expanding market activity outside of banks to include non-financial corporates or asset backed commercial paper. We hope that any future work on credit sensitive alternatives to SOFR can properly take into account the risks of reduction in activity during periods of market stress.

Market impact: wider LIBOR-FF, higher ’22 ED rates

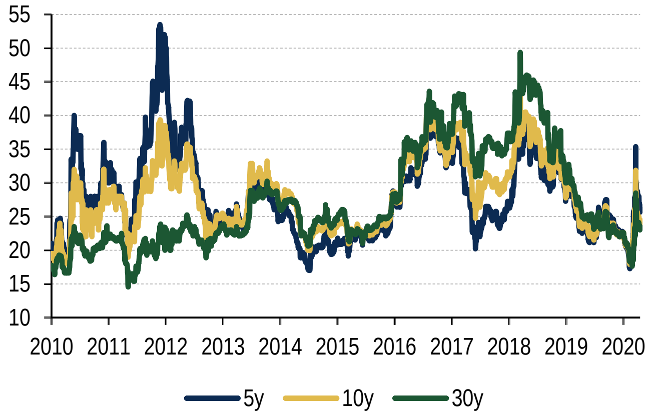
As we have previously argued, a potential USD LIBOR transition extension beyond '21 would likely result in a LIBOR-FF spread widening in the 5-10Y sector or an increase in ‘22 Eurodollar rates. We see these positions as relatively low cost ways to position for a potential extension of the LIBOR transition.

Longer term LIBOR-FF spreads have recently converged to 24-26bps as market participants have broadly assumed that ISDA USD LIBOR fallback and spread adjustment conventions would be adopted (Chart 11). Assuming a new LIBOR transition date is announced, we would expect to see LIBOR-FF trade more freely in its historical range, which is on average higher than current levels (Table 2). We would also expect to see LIBOR trade higher in relation to SOFR than may be expected by the market today.

Similarly, we might expect Eurodollar contracts maturing in 2022 to price in more upside LIBOR risk than exists today given the possibility of a transition extension. The March ’22 Eurodollar contracts implies a yield of 32 bps with FRA-OIS at 20 bps. This assumes very limited potential for the Fed to raise rates in the next 2Y and a credit spread that is below the average level that prevailed from the start of 2010 through the start of 2020.

Wider LIBOR-FF & higher ’22 ED rates would likely benefit from any LIBOR transition extension given their potential to price more upside credit risk vs today.

Chart 11: Long term LIBOR-FF has converged to around 24-26 bp



Source: BofA Global Research, Bloomberg

Table 2: LIBOR-FF spreads, current level vs historical averages

	5y	10y	30y
Current	26.1	24.5	23.5
Avg since 2010	27.9	28.1	27.2
Avg since 2016	29.0	30.8	33.5

Source: BofA Global Research, Bloomberg

Conclusion: COVID-19 likely puts LIBOR deadline at risk

COVID-19 disruptions could pose a risk in delaying the USD LIBOR to SOFR transition deadline a number of months or quarters. The official sector appears to be very resistant to adjusting deadlines around the LIBOR transition date despite a material shift in business priorities stemming from the pandemic. A delay in the transition would allow market participants more time to prepare, allow for a further adoption of SOFR in both markets and loans, and develop credit sensitive options as the market moves away from LIBOR. Any USD LIBOR transition deadline would likely support wider LIBOR-FF & higher ’22 ED rates.

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