

The path to SOFR becomes clearer

The US now has a clearer plan for transition to SOFR. There is a set of timelines in various loan products spanning through 2020/21. There is also an ambition to have SOFR as the "go to" for USD derivatives by March 2021. Lots needs to happen between now and then. Consistency between ISDA - ARRC on the spread is a next step. But end-2021 remains the unwavering goal



The ARRC sets out some key deadlines for loans transition to SOFR

There has been some talk in recent months of a potential delay in reforming the London Inter-Bank Offered Rate due to Covid-19 complications. The latest update from the Alternative Reference Rates Committee (ARRC) tasked with mapping out the transition process from Libor to SOFR (Secured Overnight Financing Rate), makes clear that delay is not probable. Rather, it is all systems go to make transition happen as planned by end 2021. In fact, a clearer set of timeline targets has been set out.

The ARRC has laid out a series of deadlines for adoption of SOFR for a series of different types of loan products through 2020 and into 2021.

1. By September 2020, new business and student loans should include ARRC-recommended fallback language, and no new applications of Libor Adjustable Rates Mortgages (ARMs).
2. By end 2020, no new Floating Rate Notes (FRNs) using Libor and maturing after 2021.
3. By mid-2021, no new Libor business loans or FRN securitizations.
4. And no new Libor Collateralised Loan Obligations (CLOs) by September 2021.

This echoes the approach being taken in the UK, where a hard deadline for the issuance of Libor-referencing loans is set for the end of March 2021. Although in fact, this has been pushed back from an earlier, quite ambitious target of September 2020. See the write-up on that [here](#).

The ARRC does the same for USD derivatives; ambitious but needs to be

These are clear and ambitious timelines that present guidelines for market participants, mapping out a path to the ultimate transition that we expect will happen at some point in 4Q 2021.

And for derivatives, there are also some key deadlines to be met.

1. SOFR discounting of new and legacy swaps is targeted to be completed by mid 4Q 2020.

That is an important step, but is more a technical one that harmonises pricing.

2. The more ambitious one is that by end-1Q 2021 dealers should have changed the market convention for quoting USD derivatives from Libor to SOFR.

This is a big one as it would be the likely beginning of a proper market in SOFR derivatives product.

Achieving that will require a big build in volumes in SOFR futures, but it is increasingly likely, in our opinion, that this will happen concurrently rather than consecutively. It is quite a leap from the current market environment where USD derivatives continue to have Libor as the clear dominant convention for market quotation. And that goes for cash interest rates swaps and interest rate futures.

To make this change will require an accelerated move towards SOFR over the course of 2020. But the biggest jump to SOFR adoption will be left until 1Q 2021, when the chips are really down and transition is facing market participants head on.

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Re-affirmation of a forward looking SOFR companion by June 2021

In addition, there is re-affirmation of an ambition to have a forward-looking SOFR term reference available by June 2021. Not exactly a new story as the ARRC had been moving in that direction in recent months. But still worthy of mention. It is not that long ago that the ARRC was suggesting that a forward-looking term rate could not be depended upon by end 2021.

So that shift has been solidified, which is important. Many segments of the market are more comfortable with SOFR in advance, which is pre-set three months ahead of payment date, as opposed to SOFR in arrears, which compounds on a daily basis right up to payment date, with the three-month rate determined by what has happened rather than what is discounted to happen in the future.

The official sector remains uncomfortable with anything that has to "guess" the future, as that in part was a rationale for a move away from Libor (which is set in advance). But it has at this juncture softened its resolve to insist on SOFR in arrears as the only preferred rate. SOFR in arrears will still be regarded as the benchmark rate, but will sit alongside the SOFR in advance, the alternative that is preferred for many in the smaller loans market segment.

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Consistency between ISDA and ARRC on the spread calculation makes complete sense

Incidentally, the ARRC has rowed in behind the International Swaps and Derivatives Association (ISDA) in terms of the calculated spread on transition from Libor to SOFR, calculated as the five-year median of the spread.

More recently, the ARRC sent out a request for feedback on a request not just to agree to the same methodology, but also to use the same spread as calculated by the ISDA.

This would seem eminently sensible as it would act to reduce basis risk on transition, at the very moment where consistency is really needed.

Strange time could prove technically optimal for transition

While many question the wisdom of persisting with the transition during these strange times, we've argued ([here](#)) from a purely technical perspective that the persistence of a low rates environment could in fact present an optimal combination of circumstances that could facilitate transition.

The thought process here centres on having a suitable amount of time for 1. a convergence of Libor on the five-year median spread to SOFR, and 2. a convergence of SOFR in advance with SOFR in arrears (the latter would happen during a period in which overnight rates are steady, and where the forward discount is benign). Here the crisis is helping the convergence process.

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