Adjustment Spreads for the Conversion of Legacy SOR Contracts to SORA

Response to Consultation Feedback

18 July 2022

Steering Committee for SOR & SIBOR Transition to SORA

(SC-STS)

PREFACE

This paper sets out the SC-STS' response to feedback that was received on the consultation paper, *Consultation on Adjustment Spreads for the Conversion of Legacy SOR Contracts to SORA*, published on 18 May 2022. Taking into account the broad support for SC-STS' recommendations, this paper sets out the finalised approach for:

a) setting the adjustment spreads within the MAS Recommended Rate in ISDA IBOR 2020 Fallbacks Protocol, Supplement number 70 to the 2006 ISDA Definitions and the 2021 ISDA Interest Rate Derivatives Definitions[1] (collectively referred to as the **"ISDA Documentation"** in this document), as well as the SC-STS' recommended contractual fallbacks for bilateral and syndicated corporate loans. These fallbacks will apply when Fallback Rate (SOR) is discontinued after 31 December 2024;

b) supplementary guidance on adjustments spreads for the period until 31 December 2024, which would support the industry's active transition from SOR; and

c) application of the SC-STS supplementary guidance to active transition across various product types.

For avoidance of doubt, this response paper covers the setting of adjustment spreads for the conversion of wholesale SOR contracts (i.e. bilateral and syndicated corporate loans, bonds, and derivatives) to Compounded SORA-in-arrears, and does not apply to earlier SC-STS guidance on the setting of adjustment spreads for the conversion of legacy SOR retail loans to Compounded SORA-in-advance[2].

No representation or warranty is given by the SC-STS as to the accuracy or completeness of the contents of this consultation, or to its suitability for any particular product and/or transaction. The SC-STS shall not be liable for any loss suffered by any person as a result of any transaction entered into on the basis of the contents of this report or which may arise from the presence of any errors or omissions in this report, and no proceeding shall be taken by any person in relation to such losses.

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[1] For avoidance of doubt, for the purpose of the ISDA Documentation, the MAS Recommended Rate referred to in this document is the rate (inclusive of any spreads or adjustments) recommended as the replacement for Fallback Rate (SOR) by the Monetary Authority of Singapore or by a committee officially endorsed or convened by the Monetary Authority of Singapore, notwithstanding that the same definition may be used in other context and refers to a different rate under the relevant ISDA definitions.

[2] Further details on the SORA Conversion Package for retail (and SME) loans based on Compounded SORA-in-advance may be found at the SC-STS webpage here.

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1 Background

1.1 **On 18 May 2022, the Steering Committee for SOR & SIBOR Transition to SORA ("SC-STS") issued a consultation paper titled *"Consultation on Adjustment Spreads for the Conversion of Legacy SOR Contracts to SORA"*** (**"the Consultation"**) to seek feedback on proposals for setting adjustment spreads for the conversion of legacy SOR contracts in wholesale markets to a SORA reference rate.

1.2 **The Consultation recommended for the adjustment spreads in the MAS Recommended Rate ("MRR Adjustment Spreads"), which applies after 31 December 2024, to be determined by a 5-year historical median of the spread between SOR and Compounded SORA-in-arrears.** The MAS Recommended Rate (**"MRR"**) serves as the contractual fallback rate in the ISDA Documentation and the SC-STS' recommended fallbacks for bilateral and syndicated business loans, that will apply when Fallback Rate (SOR)[3] is discontinued after 31 December 2024.

1.3 **In addition, to support the industry's active transition from SOR in the current period, the Consultation recommended supplementary guidance for adjustment spreads until 31 December 2024.** These adjustment spreads were proposed to be based on a linear interpolation between a reference spread based on a recent and shorter historical median of the SOR-SORA spread (**"Reference Spot Spreads"**) and the MRR Adjustment Spreads that would apply after 31 December 2024. The Consultation further recommended that the adjustment spreads until 31 December 2024 under this set of supplementary guidance should be applied directly without need for further negotiation for unhedged loans, and can be a starting point for discussions among counterparties for bilateral derivatives and hedged loans.

1.4 **Feedback was received from a total of 44 respondents, comprising 35 banks and 9 non-bank respondents.** The SC-STS thanks all respondents for their feedback.

1.5 **This paper summarises the SC-STS' response to the feedback and the finalised approaches for the Consultation's recommendations.** Further guidance on technical and implementation issues, such as the formula and computation of the various adjustment spreads, is expected to be published by end-September 2022.

[3] Fallback Rate (SOR) is an FX-implied rate, based on actual transactions in the USD/SGD FX swap market, calculated with reference to Fallback Rate (SOFR) in place of USD LIBOR rates. The calculation methodology for Fallback Rate (SOR) can be found here.

2 Feedback on MRR Adjustment Spreads

2.1 Approach for Setting the MRR Adjustment Spreads

2.1.1 **42 respondents (95%) agreed with the recommendation to determine the MRR Adjustment Spreads based on the historical median of the spread between SOR and Compounded SORA-in-arrears ("Approach 2").** Respondents cited greater transparency and robustness under this approach, as well as ease of implementation and communication, which would support wider adoption by non-bank customers.

2.1.2 **1 respondent (2%) preferred to determine the MRR Adjustment Spreads using the historical SOR-SORA basis swap forward-implied prices** (**"Approach 1"**), as it was felt that the approach was more economically appropriate.

<u>Response</u>

2.1.3 **The MRR Adjustment Spreads will be determined using the historical median of the spread between SOR and Compounded SORA-in-arrears.** The strong agreement on Approach 2 by almost all respondents is important given that the MRR Adjustment Spreads will be used by a wide range of wholesale market participants.

2.1.4 **The SC-STS notes that while Approach 1 would minimise value transfer risk by using market determined prices over a recent historical period, there are significant implementation challenges to overcome in the construction of a robust adjustment spread curve.** In particular, given the lack of SOR-SORA basis swaps transaction data[4], the construction of the adjustment spread curve would have to be based on indicative prices (e.g. from broker screens) or derived from market polls, and would be less robust.

2.2 Lookback Period for Median SOR-Compounded SORA Spread

2.2.1 **41 respondents (93%) agreed with the proposed 5-year lookback period to compute the MRR Adjustment Spreads, starting from the publication date of this consultation response.** Respondents that supported the 5-year lookback period cited its consistency with the credit spread adjustment for LIBOR in the ISDA IBOR 2020 Fallbacks

[4] Transactions data for SOR-SORA basis swaps is not readily available now that liquidity in the SOR-SORA basis swap market has tailed off. In addition, most SOR-SORA basis swaps trades are booked separately as interest rate swaps referencing SOR and overnight indexed swaps referencing SORA.

Protocol, and that an averaging period of 5 years would be sufficiently long to smooth out effects of idiosyncratic market events.

2.2.2 **3 respondents (7%) disagreed with the proposal.** They were of the view that the 5-year lookback period from the publication date in 3Q 2022 might not be sufficiently representative of a normal economic cycle, especially with the COVID-19 pandemic outbreak in 2020 and the recent interest rate tightening cycle. One of the three respondents suggested a 10-year lookback period instead.

Response

2.2.3 **The MRR Adjustment Spreads will be calculated using a 5-year lookback period ending 18 July 2022[5].** The SC-STS acknowledges the broad support from most respondents that the 5-year lookback period is adequately long, and that the use of a median spread mitigates the impact of potential outliers.

[5] The SC-STS will publish further guidance on the computation of the MRR Adjustment Spreads around September 2022.

3 Feedback on Supplementary Guidance

3.1 Methodology for Supplementary Guidance

3.1.1 **35 respondents (80%) agreed with the proposed methodology for the supplementary guidance** – i.e. the Reference Spot Spreads will be computed from recent historical median spreads between SOR and Compounded SORA, and adjustment spreads applying in periods until 31 December 2024 will be computed using a linear interpolation.

3.1.2 **Among those respondents that agreed with the proposed methodology, 20 preferred to use a 6-month historical median of the spreads between SOR and Compounded SORA as the Reference Spot Spreads.** Given the volatility in the daily spread between SOR and Compounded SORA-in-arrears, these respondents felt that a longer 6-month period would be more effective in smoothing out the volatility compared to a 3-month period. 6 respondents preferred using a 3-month historical median, reasoning that the shorter duration would better reflect current market conditions, while 8 respondents had no preference between either. 1 respondent preferred a longer period of 1-year to further smooth out the volatility.

3.1.3 **8 respondents (18%) disagreed with the proposed methodology, with the most common reason being that it was complex to use across different contracts.** Under the proposed methodology, contracts with different conversion dates and maturity dates will have different adjustment spreads. These respondents proposed that it would be simpler to use the MRR Adjustment Spreads even for periods until 31 December 2024, as all contracts referencing the same SOR tenor will then have the same adjustment spread. Respondents also noted that this would be in line with the LIBOR transition.

3.1.4 **Other feedback received**: One respondent commented that the Reference Spot Spreads could potentially be higher than the MRR Adjustment Spreads and deter transition. One respondent preferred to use the spreads between SOR and Compounded SORA on the conversion date as the Reference Spot Spreads, as they would be most reflective of prevailing market conditions. This respondent also proposed to hold the spreads constant to 31 December 2024 instead of a linear interpolation.

Response

3.1.5 **The SC-STS is of the view that it would be inappropriate to use the MRR Adjustment Spreads as the spread adjustment for periods until 31 December 2024.** The SC-STS had noted in the Consultation that shorter tenor SOR-SORA basis swaps (i.e. up to 2Y) tend to be affected more by recent differences between SOR and SORA benchmarks. Hence, the application of the MRR Adjustment Spreads for conversion of short tenor SOR contracts could introduce significant market distortion to prevailing SOR and SORA markets at the point of announcement.

3.1.6 **Regarding the possibility that the Reference Spot Spreads could be higher than the MRR Adjustment Spreads, the SC-STS is of the view that this is unlikely to negatively impact active transition.** The Reference Spot Spreads measure the recent difference between SOR and Compounded SORA-in-arrears. Intuitively, the sum of Compounded SORA-in-arrears and the Reference Spot Spreads should hence still be comparable to SOR. The SC-STS would also like to reiterate that the Reference Spot Spreads will be computed using the difference between SOR and Compounded SORA-in-arrears (i.e. the interest periods have to be aligned), and that Compounded SORA-in-arrears has been increasing at a comparable pace to SOR.

3.1.7 **Regarding the suggestion to use the spreads between SOR and Compounded SORA on the conversion date as the Reference Spot Spreads, the SC-STS notes that the broad support for a 6-month historical median affirmed the desire for an approach that smoothens volatility. Furthermore, using the spreads between SOR and Compounded SORA on the conversion date may slow transition.** First, counterparties could be incentivised to wait until the Reference Spot Spreads are more favourable before converting their SOR contracts. Second, given that each conversion date will have different Reference Spot Spreads, computation of the relevant adjustment spreads will be more complex and harder to communicate, which could impede broader adoption by market participants. Relatedly, on the proposal to hold the spreads constant until 31 December 2024, this could introduce a cliff effect, where the adjustment spreads increase significantly after end-2024. This cliff effect is not reflective of existing SOR-SORA basis swap pricing, where the basis swap curve is sloping towards the historical median.

3.1.8 **Given the broad support from the consultation, the Reference Spot Spreads will be determined by a 6-month historical median starting from 18 July 2022.** Specifically, the Reference Spot Spreads would be determined by the historical median spreads between Compounded SORA rates from around[6] 19 January 2022 to 18 July 2022, and SOR rates for the relevant periods corresponding to these Compounded SORA rates.

- 1-month Compounded SORA rates in this period would be compared to 1-month SOR rates published from around 19 December 2021 to 18 June 2022;

[6] The specific dates may change slightly following further analysis on weekend/holiday calendars, day count conventions and other such technical considerations, to be reviewed by SC-STS.

- 3-month Compounded SORA rates in this period would be compared to 3-month SOR rates published from around 19 October 2021 to 18 April 2022; and
- 6-month Compounded SORA rates in this period would be compared to 6-month SOR rates published from around 19 July 2021 to 18 January 2022.

The SC-STS would like to reiterate that the supplementary guidance is intended for market participants that are considering actively converting their SOR contracts to SORA before end-2024. Existing fallback provisions (e.g. to Fallback Rate (SOR)) upon SOR discontinuation after 30 June 2023 will not be affected.

3.1.9 **To ameliorate concerns about the complexity involved in computing the relevant adjustment spreads, the SC-STS plans to introduce an adjustment spread calculator around end-3Q 2022.** The tool will be available online and will allow users to compute the adjustment spreads based on the tenor and remaining maturity of their contract.

3.2 Scope of Application for Supplementary Guidance

3.2.1 **40 respondents (91%) agreed with the proposed approach for application of the supplementary guidance across product types.** Most respondents agreed that flexibility in applying the supplementary guidance would be helpful where SOR derivatives are involved. Valuation of derivatives are generally marked to market, and a conversion at historical pricing could introduce significant valuation impacts for counterparties.

3.2.2 **Other feedback received**: 2 respondents (5%) commented that the flexibility could slow transition, especially for hedged club or syndicated loans where negotiations have been protracted and counterparties are unable to come to a common understanding on the adjustment spread. 1 respondent proposed that for hedged loans where the customer hedges with the same bank that it borrows from, the recommended spreads should be applied directly without need for further negotiation. 1 respondent disagreed with the proposal, on the assumption that the supplementary guidance would be adopted in LCH's mandatory conversion of cleared SOR derivatives.

Response

3.2.3 **The SC-STS notes the strong support from almost all respondents for the application of the supplementary guidance to be flexible.** While allowing for flexibility may lead to lengthy discussions in some cases and especially in complex multi-party contracts, the SC-STS has observed that in the absence of such flexibility, it could prove challenging to even kickstart discussions.

3.2.4 **It is premature to conclude what approach LCH will adopt in its mandatory conversion of cleared SOR derivatives.** LCH is only expected to consult later this year on the specific methodology for the automatic conversion of outstanding SOR swaps to SORA. While the LCH consultation will consider the SC-STS' guidance – particularly on the setting of the MRR, which apply directly as fallbacks in the relevant cleared SOR contracts, rather than SC-STS' Supplementary Guidance – LCH may not necessarily consult on the same approaches.

3.2.5 **Therefore, the SC-STS recommends the following approach to be used for applying the supplementary guidance on adjustment spreads for active transition across the following product types**:

- For unhedged loans, the recommended spreads should be applied directly without need for further negotiation.
- For bilateral derivatives and hedged loans, the recommended spreads can be a starting point for counterparty discussions. Nonetheless, the following principles should be adhered to:
    - Customers should be informed of the reason why the spreads for the conversion may differ from the supplementary guidance, if there are deviations.
    - In addition, for loans that are hedged with the same bank or group of banks, the loan and the corresponding derivatives should be converted concurrently at the same spread as determined by the lending bank or group of banks.

4 Other Feedback and Clarifications

Clarifications on technicalities

4.1 Several respondents sought clarifications on the definition for the MAS Recommended Rate e.g. Compounded SORA conventions. One respondent sought clarifications on the effective date of the Reference Spot Spreads. Several respondents sought clarifications on the interpolation frequency and methodology between the Reference Spot Spreads and the MRR Adjustment Spreads.

Response

4.2 The SC-STS will publish further guidance on technical and implementation issues around September 2022. The guidance will include:

- The formula and computation of MRR Adjustment Spreads;
- The formula and computation of the Reference Spot Spreads;
- The formula and computation of the interpolated adjustment spreads to apply between 18 July 2022 and 31 December 2024; and
- The definition of the MRR, including the conventions for Compounded SORA to apply within.

SOR loans with chooser options

4.3 One respondent proposed that the 3-month SOR to SORA adjustments spreads should apply to unhedged SOR loans with chooser options (i.e. loans where borrowers have the option to choose between SOR tenors at each interest reset). It was proposed that the middle tenor (i.e. 3-month SOR) be used as representative of the range of options available to borrowers before and after the transition.

Response

4.4 The SC-STS agrees that it would generally be reasonable to apply the 3-month SOR to SORA adjustment spreads to the transition of unhedged SOR loans with chooser options, given that the customer retains the optionality to switch reference rate tenors and the interest rate reset periods. However, there may be instances where customers have historically only used 1-month SOR, and have the intention to continue to make payments on a monthly basis after the transition to Compounded SORA. In such cases, banks should consider if it may be more appropriate for a 1-month SOR to SORA adjustment spread to apply instead.

Impact on SOR-SORA markets

4.5 One respondent noted that pricing in the SOR-SORA basis swap markets in the longer tenors have trended towards the current 5-year historical median spread between SOR and Compounded SORA, and raised the possibility that SC-STS members may have acted on market-sensitive information obtained from the Consultation process.

Response

4.6 **The SC-STS treats very seriously its responsibility to safeguard the confidentiality of sensitive information, and has implemented precautions to prevent the misuse of such information arising in the course of the necessary work performed by its members.** These include:

- Setting out clear expectations around safeguarding confidentiality of information in the guidelines to the Terms of Reference of the committee[7], and supporting this with specific training for SC-STS members.
- Taking practical governance steps to limit access to market data and information concerning key proposals that have the potential to affect market prices, and to publish any conclusions as soon as possible following SC-STS' endorsement.
- Ensuring that the collation of sensitive and specific information concerning market exposure and data from individual market participants is only carried out by the SC-STS secretariat (comprising staff from the Monetary Authority of Singapore and the Association of Banks in Singapore).

4.7 The SC-STS further notes that market pricing in the basis swap markets for the longer tenors (of 5-years and above) had already converged to levels close to the current 5-year historical median spread since August 2021, as shown in Figure 1. This was much earlier than the commencement of initial SC-STS discussions on the Consultation in early 2022. In particular, the SC-STS' discussions on the specific recommendations pertaining to the 5-year historical median spread approach took place only in late April 2022.

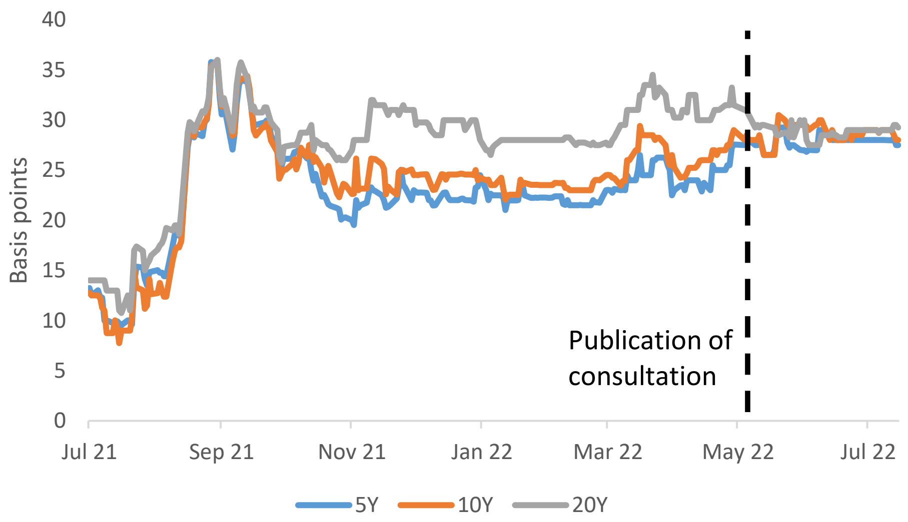
4.8 **There is, as such, no evidence to conclude that the SC-STS members have acted on market-sensitive information obtained from the Consultation process.** Nonetheless, a concerned party who has specific and substantive evidence that a party may have acted on

[7] The Terms of Reference of SC-STS can be found here.

market-sensitive information obtained from the Consultation process, should file a report to the Monetary Authority of Singapore for investigation at:

- https://eservices.mas.gov.sg/consumerfeedback/ if it pertains to regulatory breaches or misconduct by a financial institution; or
- https://singapore.deloitte-halo.com/MAS/ if it pertains to an MAS staff.

Figure 1: 6M SOR-SORA basis swap prices



5 Conclusion

5.1 **The SC-STS thanks all respondents for the feedback to the key recommendations set out in this consultation**. The conclusions from this process confirm the key parameters of the MRR, and the SC-STS' supplementary guidance on adjustment spreads to apply for interest rate periods before end-2024.

5.2 **The outcome of this consultation provides clarity on the pathway for the transition of legacy SOR contracts to SORA, further supporting transition and contract remediation, including for complex and hard-to-transition legacy SOR exposures.** Market participants have already made significant progress in reducing their exposures to SOR, particularly following SC-STS' July 2021 *Recommendations for Transition of Legacy SOR Contracts*[8]. This paper provides further guidance for the industry to complete its transition from SOR.

- First, the SC-STS' supplementary guidance will be immediately useful to further support active transition from legacy wholesale SOR contracts to SORA, particularly for complex and syndicated transactions.
- Second, the setting of the MRR will serve as a useful point of reference for clearing houses' automatic conversion of cleared SOR derivatives to SORA, which will take place before 30 June 2023.
- Finally, the MRR provides contractual and valuation certainty for wholesale SOR contracts that may remain outstanding after 31 December 2024 when Fallback Rate (SOR) will be discontinued.

5.3 **The SC-STS therefore strongly encourages market participants to leverage on this guidance, to further progress the transition and contract remediation of all outstanding legacy SOR exposures.**

- Active transition to SORA will help market participants to avoid excessive reliance on contractual fallbacks, including attendant operational risks arising from the activation of such fallbacks en masse.[9]

[8] See the SC-STS report, "Recommendations for Transition of Legacy SOR Contracts" (29 July 2021).

[9] Market participants with exposures to Fallback Rate (SOR), especially if the contract matures beyond the discontinuation of Fallback Rate (SOR) of end-2024, can and should seek to actively convert their contracts to SORA as far as possible.

- Active transition to SORA will also reduce basis risk against cleared SOR derivatives contracts when these are converted by clearing houses to SORA before the discontinuation of SOR by 30 June 2023.

- Where active transition to SORA cannot be pursued, market participants should ensure the incorporation of adequate fallbacks into their legacy SOR contracts.[10] In many cases, Fallback Rate (SOR) will apply and market participants should carefully examine the conclusions from this consultation, to understand the implications to their contracts when the MRR takes effect after Fallback Rate (SOR) is discontinued after 31 December 2024.

5.4 **The committee's guidance, alongside diligent action by market participants, will ensure a smooth transition as we draw closer to the discontinuation of SOR after 30 June 2023.**

[10] Refer to the 18 July 2022 Addendum to SC-STS Timelines to Cease Issuance of SOR Derivatives and SIBOR-Linked Financial Products, originally published on 31 March 2021. This outlines SC-STS' guidance on the active transition and contractual remediation of outstanding SOR contracts.