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Regulatory Considerations in the Death of LIBOR — Recent Guidance Suggests a Partial Stay of Execution

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Who Needs to Know

Lenders and borrowers involved in financing transactions, any companies using LIBOR swap or derivative transactions.

Why It Matters

All lenders, borrowers, investors, and other users of LIBOR-based transactions need to remain current on the status of the LIBOR transition.

Recent regulatory guidance indicates that the transition from LIBOR will be a significant focus for numerous regulatory bodies over 2021. Following a brief introduction highlighting the background and current status of the transition from LIBOR, this update will focus on recent regulatory and compliance guidance for identifying and mitigating risks during this transition period.

Proposed Alternate US Rate

To frame the significance of the LIBOR issue, estimates have suggested there are more than 200 trillion U.S. dollar (USD) LIBOR contracts outstanding, with approximately $500 million of daily three-month LIBOR trades forming the basis for the LIBOR curve. This creates an unstable reliance on a relatively small and increasingly shrinking base. The Alternative Reference Rates Committee (ARRC) was formed in November 2014 by the Federal Reserve Board of Governors and the Federal Reserve Bank of New York (FRBNY) to identify one or more alternatives to LIBOR and to develop plans for adoption, transition, and best practices for use. ARRC identified the Secured Overnight Financing Rate (SOFR) as the preferred alternative rate, and the FRBNY began publishing SOFR on April 3, 2018.

SOFR, which is measured on the cost to borrow cash overnight collateralized by U.S. Treasuries and calculated based on overnight Treasury repurchase agreement transactions, was identified by ARRC based on feedback from consultations and members of the ARRC advisory group. A side-by-side comparison of LIBOR and SOFR is illustrative of some of the core differences between the two reference rates:

Differences between LIBOR and SOFR:

LIBOR	SOFR

• Survey +$500 million of daily trading	• $1 trillion of daily trading
• Unsecured	• Secured
• Available for five currencies	• Only for USD
• Hypothetically reflects bank cost of funds	• Risk-free rate
• Rises in a market disruption/time of increased credit risk	• May stay the same or even fall in a market disruption/time of increased credit risk
• Forward looking/various terms	• Backward looking/overnight
• Established (30 years+)	• New as of April 2018

OCIE Risk Alert

The SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert on June 18, 2020, highlighting risks associated with preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate. The OCIE alert states, "Preparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation. The risks associated with this discontinuation and transition will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner." Therefore, OCIE noted that preparedness for the transition will be an examination program priority for 2020. While OCIE Risk Alerts are not rules and do not create, alter, or amend applicable law, this should be viewed as another effort to encourage swift action to address and mitigate the impacts of the LIBOR transition. Appendix A of the Risk Alert sets out a 20-point illustrative list of information and documentation regarding a registrant's LIBOR transition that may form the basis of SEC examinations, and this list offers a useful guide for activities and considerations. Highlights include:

1. Organization structure, particularly regarding those impacted by the discontinuation of LIBOR transition and transition to an alternative rate (collectively, the LIBOR Transition).
2. Information regarding organizational support and workstreams engaged in the LIBOR Transition.
3. The identity of any third-party support for the LIBOR Transition.
4. Impacted contracts, benchmarks and fee structures, and analysis, timelines, and remediation plans related thereto, including with respect to fallback language and use of any LIBOR alternatives (*e.g.,* SOFR).
5. Risk analysis, including inventories, valuations, modeling, and vulnerabilities.
6. Evidence of engagement of a public company board, or equivalent governing bodies or offices, if registrant is not a public company.
7. Third-party vendor and information technology impacts (*e.g.,* accounting, investor reporting, risk, valuation, or trading) to accommodate the LIBOR Transition, including any changes to accommodate new instruments/contracts and rates with features that differ from LIBOR.
8. Disclosures in SEC filings and/or to investors about the LIBOR Transition, including fallback language for LIBOR instruments, and any guidance provided by registrant to employees or supervised persons concerning LIBOR-related investment recommendations or the LIBOR Transition.
9. Any implemented or planned changes to compliance procedures, controls, or tools related to the LIBOR Transition.

FFIEC Statement

The Federal Financial Institutions Examination Council (FFIEC) issued a July 1, 2020 statement highlighting LIBOR transition risks and expectations and guidance to minimize adverse effects on financial markets, firms, and investors resulting from the expected discontinuation of LIBOR. As noted by the FFIEC, "[t]he financial services industry uses LIBOR as a reference rate for many financial products and instruments that include loans, investments, and deposits to a range of customers, as well as borrowings and derivatives. . . . While some smaller and less complex institutions may have limited exposure to LIBOR-denominated instruments, the transition to alternative reference rates will affect almost every institution." The FFIEC statement noted that financial institutions should focus on risk management processes to identify and mitigate risks. Risks identified by FFIEC associated with on- and off-balance sheet assets referencing LIBOR include the following:

- Operational difficulty in quantifying exposure;
- Financial, valuation, and model risk related to reference rate transition;
- Inadequate risk management processes and controls to support transition;
- Consumer protection-related risks;
- Limited ability of third-party service providers to support operational changes; and
- Potential litigation and reputational risk arising from reference rate transition.

The FFIEC statement highlighted, as another significant risk, issues with fallback language in financial contracts specifying how the replacement of a discontinued reference rate will be handled. FFIEC noted that many existing contracts contain fallback language designed for only a temporary unavailability of LIBOR rather than permanent discontinuance. In addition, as noted in the FFIEC statement, different contracts within departments of financial institutions, as well as applicable third-party contracts for servicing and other purposes, may use a variety of different fallback provisions, making assessment of risks even more difficult.

As noted in the July 12, 2019 guidance from the SEC's Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant, impacted registrants should be actively involved in identifying, evaluating, and mitigating other consequences of the discontinuation of LIBOR beyond those related to existing or new contracts, including financial, operational, legal, regulatory, technology, and other risks.

THE OCIE Risk Alert observes that impacted financial institutions are utilizing third-party consultant support, as well as tools, such as artificial intelligence, to digitize and analyze the millions of LIBOR-based contracts currently active.

Late 2020 Updates

A flurry of events in late 2020 changed the LIBOR transition landscape. While not a comprehensive list, some of the most significant are highlighted here:

First, in the fall of 2020, ARRC updated its "Best Practices for Transition from LIBOR." Then, on October 9, 2020, ISDA published a statement from its board of directors, announcing that ISDA would launch the IBOR Fallbacks Supplement to the 2006 ISDA Definitions and the ISDA 2020 IBOR Fallbacks Protocol on October 23, 2020, noting that the supplement and the amendments made by the protocol will take effect on January 25, 2021. On this date, all new derivatives contracts that incorporate the 2006 ISDA Definitions and reference one of the covered IBORs will contain the new fallbacks, and derivatives contracts existing as of this date will incorporate the new fallbacks if both counterparties have adhered to the protocol or otherwise bilaterally agreed to include the new fallbacks in their contracts.

Legislative efforts to address so-called “tough legacy” contracts that would mature after December 31, 2021 also continued in October and November 2020, with legislation introduced at both the NewYork and federal levels, closely following the ARRC proposed remedial legislation model. Based on statements from Federal Reserve Board Governor Randal K. Quarles, who also serves as the board’s vice chair for supervision, regarding efforts to “combine current measures that allow the bulk of the existing contracts to mature on their existing terms and then save legislation for the hard tail when we’ve had time to think about it,” actions that emerged over November 2020 may have become a more significant near term focus than the legislative efforts.

On November 6, 2020, the Board of Governors of the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC, and collectively, the agencies) issued a statement that reiterates that they are not endorsing a specific replacement rate for LIBOR for loans. The statement indicated that a bank may use any reference rate for its loans that the bank determines to be appropriate, but emphasized that banks should include fallback language in lending contracts that provides for use of a robust fallback rate if the initial reference rate is discontinued. Continuing the pressure on continued preparations for LIBOR transition, the statement further encouraged banks to begin transitioning loans away from LIBOR without delay, to accelerate outreach to lending customers to ensure that they are aware of, and prepared for, the transition from LIBOR, and to consider any technical changes that might be required for internal systems to accommodate new reference rates or fallback rates. The November 6 publication acknowledged the concerns some banks have raised that because SOFR is a near-risk-free rate, it may not reflect banks’ underlying funding costs, and noted the recent and continued advocacy for the development of a credit-sensitive rate or a credit-sensitive spread that could be added to SOFR to better reflect banks’ funding cost, and ongoing “Credit Sensitivity Group” workshops that have been held over 2020 among interested banks and the agencies. While the final Credit Sensitivity Group working session will be held via webinar in January 2021, a letter dated October 21, 2020 from the Department of the Treasury, the Fed, the FRBNY, the OCC, the SEC, the FDIC, and the Commodity Futures Trading Commission publicly confirmed the official sector would not recommend a specific credit-sensitive supplement or rate for use in commercial lending products.

Then on November 30, 2020, ICE Benchmark Administration (IBA) issued an announcement of consultation on a possible extension to continue publishing certain LIBOR tenors until June 30, 2023. Additional guidance is expected after the consultation period closes January 25, 2021. As proposed, while the one-week and two-month USD LIBOR would still sunset after December 31, 2021, the date for the overnight and one-, three-, six-, and 12-month USD LIBOR settings would be extended to June 30, 2023. This announcement was supported the same date by a joint statement on LIBOR Transition from the agencies, as well as a supporting statement from LIBOR’s regulator and the United Kingdom’s Financial Conduct Authority (FCA). As described in a press release from the Fed, “[t]he announcements … 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.” The cessation of publication of the little-used, one-week and two-month USD LIBOR could provide a test case market, while still necessitating continued readiness preparations, while the extension for most to mid-2023 allows an additional grace period for legacy contracts to run their course. The agencies also issued a stern warning to banks that entering into new USD LIBOR-based contracts creates safety and soundness risks, and they encouraged banks to stop entering into those contracts by the end of 2021. Finally, the statement importantly clarifies that for purposes of the ISDA transition language, the joint statement and other end of 2020 actions should not be viewed as a triggering event.

Conclusion

The above examples of recent regulatory guidance regarding the LIBOR Transition are illustrative of the sweeping impact it is having on financial institutions and others. The COVID-19 pandemic is stressing resources available for the transition efforts, and numerous other challenges to the transition from LIBOR have emerged. There has been some easing of interim deadlines. For example, on April 29, 2020, Britain's Financial Conduct Authority extended the deadline for the use of LIBOR in new loans from the end of the third quarter of 2020 to the end of the first quarter of 2021 in consideration of the challenges and exigencies of the COVID-19 pandemic. More recently, the "stay of execution" from the IBA has provided additional relief to facilitate an orderly winddown and allow more current LIBOR transactions to expire on their own terms prior to the cessation of the publication of LIBOR. Regardless of the extension for certain USD rate references, the ultimate deadline of the expected sunset of LIBOR for at least certain USD and other rating measures after the end of 2021 remains, and therefore transition efforts must continue apace in order to timely mitigate the impacts described above.

Attachment 1: **RECENT UPDATES: LIBOR TRANSITION RESOURCES**

- Updates from Alternative Reference Rates Committee: https://www.newyorkfed.org/arrc, including December 4, 2020 Guide on LIBOR Transition.
- ARRC Proposed Remedial Legislation, as well as proposed N.Y. legislation [October 28, 2020, New York State Senate Bill S9070 (S9070)], https://nyassembly.gov/leg/?bn=S09070&term=2019, and legislation at the federal level proposed by Brad Sherman, Democrat representative for California's 30th District and chairman of the House Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, which largely mimics legislation introduced in the New York State legislature.
- SEC Staff of the Office of Compliance Inspections and Examinations (OCIE) Risk Alert: Examination Initiative: LIBOR Transition Preparedness, and Appendix, June 18, 2020, https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative_1.pdf.
- FFIEC Statement, July 1, 2020 (and note additional resources listed at end of statement) https://www.ffiec.gov/press/PDF/FFIEC%20Statement%20on%20Managing%20the%20LIBOR%20Transition.pdf.
- https://www.doddfrankupdate.com/DFU/ArticlesDFU/Regulators-highlight-LIBOR-transition-risks-79663.aspx.
- ARRC Best Practices for Transition from LIBOR, last updated September 3, 2020, https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf.
- October 9, 2020, ISDA statement from its board of directors, announcing that ISDA would launch the IBOR Fallbacks Supplement to the 2006 ISDA Definitions and the ISDA 2020 IBOR Fallbacks Protocol on October 23, 2020. https://www.isda.org/2020/10/09/isda-board-statement-on-the-ibor-fallbacks-supplement-and-protocol/.
- November 6, 2020, Joint Statement on Reference Rates for Loans, Fed, OCC, and FDIC. https://www.fdic.gov/news/financial-institution-letters/2020/fil20104a.pdf.
- November 25, 2020, *JD Supra*, "Signals or Noise in November for LIBOR Transition?" https://www.jdsupra.com/legalnews/signals-or-noise-in-november-for-libor-25801/.
- November 30, 2020, ICE Benchmark Administration (IBA) announcement of consultation on a possible extension to continue publishing certain LIBOR tenors until June 30, 2023. https://s2.q4cdn.com/154085107/files/doc_news/ICE-Benchmark-Administration-to-Consult-on-Its-Intention-to-Cease-the-Publication-of-One-Week-and-Two-Month-USD-LIBOR-Settings-at-End-ELPZZ.pdf.
- November 30, 2020, Joint Statement on LIBOR Transition from Fed, OCC, and FDIC, and Fed Press Release, https://www.federalreserve.gov/supervisionreg/srletters/SR2027.htm, and

https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf.

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