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Winter 2019 LIBOR Transition LinkWrap: A Compendium of Recent Developments

Friedman Kaplan LIBOR Transition Task Force

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What's happening right now in the world of LIBOR transition? Friedman Kaplan's LIBOR Transition Task Force sees five major themes:

1. **The Sterling LIBOR market has made significant progress, while the USD LIBOR market is facing resistance and procrastination, and UK and US regulators are striking different tones in their messaging.**

UK market participants continue to make major progress toward widespread adoption of SONIA as a replacement for Sterling LIBOR. Numerous new SONIA-based offerings have been launched, and the first transaction switching an existing securitization to SONIA was completed in early October.

There are a number of reasons the Sterling LIBOR market is finding it easier to move to SONIA and is much closer to wholesale adoption of the new benchmark. Among other things, the Sterling LIBOR market is a fraction of the size of the USD LIBOR market, and Sterling LIBOR is not used in many asset types where USD LIBOR is commonly used, such as floating rate notes, RMBS and other ABS. Sterling LIBOR market participants also are helped in transitioning to SONIA and adding robust fallback language by market conventions that allow for amendments to many types of transactions with less than 100% holder approval, whereas many documents for similar USD LIBOR transactions require unanimous holder consent.

UK regulators continue forcefully to urge market participants to move away from LIBOR. In July, the FCA's Andrew Bailey spoke at a SIFMA LIBOR Transition Briefing and said:

The base case assumption should be that there will be no LIBOR publication after end-2021. Even if LIBOR does continue for a further period after end-2021, it would have changed. There is a high probability it will no longer pass regulatory tests of representativeness. Markets for LIBOR-related contracts are likely to have become highly illiquid. It may not be usable in new contracts. The ability to hedge outstanding LIBOR obligations and claims is likely to have been impaired. The future for those still on LIBOR will be more uncertain than ever. Transition – and transition comfortably before end-2021 – is a better choice.

Similarly, the Bank of England's July Financial Stability Report and Record noted that "The continued reliance of global financial markets on Libor poses risks to financial stability that can be reduced only through a transition to alternative benchmark rates by end-2021. There is no justification for firms continuing to increase their exposures to Libor. The pace of market participants' transition efforts now needs to accelerate and the [Financial Policy Committee] will monitor progress closely." The question then arises whether the solution to the risk to financial stability posed by LIBOR is a conversion that itself creates a risk to financial stability.

In September, the Bank of England and the FCA (the latter of which regulates LIBOR), said they will begin to ask more market participants – not just the large institutions that received a "Dear CEO" letter in 2018 – for detailed updates on their LIBOR-transition preparedness. In November, the FCA released an FAQ on "conduct risks" associated with LIBOR transition.

Not everyone in the UK is sold on the discontinuation of LIBOR, though. Notably, a former board member of the UK Financial Services Authority argues that the FCA should "[r]equire banks to continue their submissions to Libor after 2021[and] [a]llow Libor to compete with other benchmarks."

Unlike in the UK, the US official sector is not speaking with one voice. Some of the rhetoric from the US official sector has become noticeably less aggressive than in the UK and increasingly appears to recognize the impossibility of transitioning the entire USD LIBOR market away from LIBOR by the end of 2021. For example, a LIBOR-transition-related blog post by the Consumer Financial Protection Bureau in mid-October noted that "Sometime after 2021, LIBOR is expected to be discontinued." A July meeting of the Financial Research Advisory Committee of the Treasury Department's Office of Financial Research discussed LIBOR transition challenges, and noted, among other things, that "the transition is too big and needs to occur too fast to rely solely on [the ARRC's] efforts."

On the other hand, the New York Fed's John C. Williams struck a more urgent tone at a September conference, saying, "Some say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes, and the end of LIBOR."

Similarly, in a mid-November speech to the Government Finance Officers Association, SEC Chair Jay Clayton warned municipal bond issuers to prepare for LIBOR to go away at the end of 2021: "I would say that playing the it's-not-going-away strategy is a high risk strategy … You know, the idea that I don't really need to worry about this, because regulators will work it out."

Consistent with this mixed messaging, in September, Accenture published the results of a study on the status of LIBOR transition, which showed a general lack of preparedness in the market and distinguished between firms that are "drivers" and those that are passengers.

Meanwhile, a number of the regulatory and other impediments to transition are being addressed. In September, FASB issued proposed "optional guidance for a limited time to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting." Comments were due October 7; the results of this consultation have not been published yet.

In the derivatives markets, ISDA continues to make steady progress toward a marketwide protocol to address LIBOR-transition issues. In July, ISDA announced the results of an initial consultation on spread and term adjustments to alternative risk-free rates (RFRs) if LIBOR fallbacks are triggered in derivatives transactions. The overwhelming majority of respondents preferred the "compounded setting in arrears rate" for the adjusted risk-free rate (RFR) and the "historical mean/median approach" for the spread adjustment. Also in July, ISDA announced that Bloomberg been selected to calculate and publish adjustments related to fallbacks that ISDA intends to implement for certain interest rate benchmarks in its 2006 ISDA Definitions.

A further consultation on the specifics of these adjustments was issued in September, and a report summarizing the responses was released in mid-November. On the spread adjustment methodology, respondents favored a historical median approach instead of a five-year lookback period, and also preferred not to include a transitional period in the spread adjustment calculation, not to exclude outliers, and not to exclude any negative spreads. For the compounded-in-arrears rate, a clear majority favored a two-banking-day backward shift adjustment for operational and payment purposes.

In contrast with these clear mandates on adjustment methodologies, ISDA's work on so-called pre-cessation triggers for LIBOR fallbacks in derivatives transactions continues to encounter a problematic lack of market consensus. Pre-cessation triggers are provisions that would activate a LIBOR fallback upon a regulatory announcement that LIBOR (or certain other IBOR benchmarks) is no longer representative of an underlying market—even if LIBOR continued to be published. In August, ISDA announced the results of its consultation on whether to implement such triggers, which showed respondents' views fell into three categories, without a clear majority in any one category. An anonymized report summarizing those responses was published in late October. ISDA CEO Scott O'Malia said that "Based on the feedback to the consultation, it would be helpful to have more clarity from regulators on the specific circumstances under which they may determine a covered IBOR to be non-representative, and the length of time during which a non-representative IBOR may be published." Financial Stability Board co-chairs Andrew Bailey of the FCA and John Williams of the NY Fed also recently urged ISDA to adopt pre-cessation triggers in amendments to derivatives documentation. There surely will be more to come on this topic in the coming months, as ISDA aims to be in a position to launch a protocol to amend the 2006 ISDA Definitions to address LIBOR-transition issues in the next quarter or so. (ISDA has previously announced that the definitions will be amended and the protocol will become available from the end of 2019, with implementation in early 2020, but this timetable now seems difficult to meet.)

For a brief period, it looked as if there would be additional excitement in the cleared swaps market when the two largest central counterparties, LCH and CME, announced over the summer that they would switch from LIBOR to SOFR for discounting on different dates that were three months apart. After much hand-wringing, CME announced in October that it would change the date of its switch to match the date announced by LCH – October 16, 2020.

Another complication that applies to buy-side firms in particular is that portfolios are not static, so LIBOR transition is not as simple as conducting an inventory of LIBOR-based portfolio positions and getting down to the work of amending documents. Some hedge funds may have quite high (over 50%) annual portfolio turnover rates, which means that a portfolio inventory conducted today is not helpful for understanding what will be in the portfolio at the end of 2021.

This, in turn, means that LIBOR transition for such funds is less about amending documents, and more about risk management. In particular, firms need to be aware when they take on new LIBOR-linked risks, as well as when LIBOR-linked transactions carry documentation risks that cannot be easily addressed (see below re: "tough legacy" transactions). In addition, as discussed in more detail below, SEC examiners and other regulators can be expected to start asking about firms' LIBOR transition plans, and articulating what may amount to a "wait and see" approach as an effective plan will be challenging. It remains to be seen what best practices will emerge in this regard.

Market participants are widely using ARRC-recommended LIBOR fallback language, but not always exactly as written. As Friedman Kaplan wrote in September, users need to take care to be sure that other contractual provisions do not undermine the effectiveness of fallback language.

2. SOFR is both gaining traction and meeting resistance. Competitors are emerging.

The biggest news on the SOFR front was the September and October volatility spikes in the repo market upon which SOFR is based, which gave many market participants pause. Further volatility is expected again at year-end. Responding to the Federal Reserve's subsequent interventions to stabilize SOFR, one commentator observed that "despite the policy decision not to require the banks to provide the guesstimates that form the basis for LIBOR, SOFR cannot become the LIBOR replacement. Something else will need creating or, as has been suggested recently, LIBOR will continue to limp along despite the objections of the regulators."

Despite these challenges, the ARRC continues to do its best to advance the cause of SOFR adoption. In early November, it released a request for public comment (due December 4) on a proposed publication of SOFR averages and a SOFR Index. In September, the ARRC published a "Practical Implementation Checklist for SOFR Adoption," although the document focuses primarily on banks. In July, the ARRC published a consultation seeking public feedback on proposed LIBOR fallback language consultation for new residential adjustable-rate mortgages. Even after the deadline was extended, a relatively small number of responses was received. The final fallback language was published in November. The ARRC also continues to tell market participants not to wait for term SOFR rates to be published, although market participants continue to plead the case for a term structure.

Some lenders have expressed concern about the use of SOFR with a static spread adjustment, such as the one that ISDA contemplates. In September, executives from ten such institutions wrote to the Fed, the OCC and the FDIC urging that development of a "a SOFR-based lending framework that includes a credit risk premium" including "a dynamic spread that reflects changes in banks' cost of funds over forward-looking term periods and is added on a periodic basis to SOFR-based rates."

In the US, a couple of alternatives to SOFR as a LIBOR replacement are gaining traction. One is AMERIBOR, which was developed by Dr. Richard Sandor, chairman and CEO of the American Financial Exchange. Sandor argues that LIBOR will be replaced in the first instance by multiple rates for various purposes. He recently told *American Banker*, "These things take years and it's not going to be a magical pill and all of a sudden one [benchmark] is going to emerge. If it does, it's going to be the first time in 500 years of western economic thinking." In August, futures trading on three-month and seven-day AMERIBOR contracts began in partnership with CBOE Futures Exchange. CME CEO Terry Duffy agrees; he told Bloomberg News, "If I had to bet, which I'm not a betting man, I would say that you'll probably have a hybrid of multiple different benchmarks" to replace LIBOR. (The CME, home of Eurodollar futures and options, recently announced its methodology for converting those instruments to SOFR, which largely follows the lead of ISDA.)

Another option is the ICE Bank Yield Index, developed by ICE Benchmark Administration, which currently administers LIBOR. In October, ICE released a third update on the development of the proposed benchmark, in which it stated, "Provided that the outcome of testing is satisfactory and IBA is able to source funding data from large banks on an on-going basis, then IBA, as an authorized and regulated benchmark administrator, expects to be able to administer and provide the [ICE Bank Yield] Index in compliance with applicable regulation for use by market participants during the second half of 2020." An interesting article in mid-November described the impact of LIBOR transition on major futures market participants, including ICE.

Despite the emergence of these two alternatives, the US official sector continues to focus almost exclusively on SOFR. For example, in early October, the Treasury and IRS proposed for comment new regulations to allow taxpayers to avoid adverse tax consequences from changing the terms of various financial contracts to replace reference rates based on LIBOR. The proposed regulations, however, leave AMERIBOR and the ICE Bank Yield Index out in the cold, focusing exclusively on SOFR for USD transactions. (Written comments on the proposal are due November 25, 2019.) Similarly, in September, the FDIC announced proposed new regulations that would allow banks to move existing trades to SOFR without having to treat them as new transactions.

3. The market has started to respond.

It is inevitable that market participants will start to seek advantages from the market disruption that already has resulted from the prospect of LIBOR transition. In August, Bloomberg's Matt Levin ("Money Stuff") weighed in with this typically incisive observation:

> **Yeah, look, I take the point, there's a lot to do and it's complicated and labor-intensive. If you're the Libor Transition Guy at a big bank, you are going to be spending so much money on lawyers and computer programmers to scour and rewrite all your contracts and code to reflect new interest-rate benchmarks. On the other hand, if you are not also the biggest profit center at the bank for the next five years, I kind of think you are doing it wrong?**

As expected, "holdout" behavior has begun. In early October, American Money Management Corp., asked investors in one if its CLOs to agree to new LIBOR fallback language as part of a refinancing of the vehicle's three most senior tranches. Investors subsequently were advised that due to a holder that did not consent to the proposed change to the fallback language, it will only apply to certain tranches of the notes. The arranging bank said it plans to add to the "holdout" tranches which were not reworked what it called "springing" Libor replacement language, which would allow for LIBOR replacement language to become effective at a later date, in case the non-consenting holder changes its mind or sells the note.

The quality (or absence) of LIBOR fallback language in certain documents also has begun to impact pricing and valuation. For example, there are reports that the quality of LIBOR fallback language is affecting pricing in some sectors such as student-loan asset-backed securities (SLABS). A number of rating agency disclosures also have noted the basis risk lurking in CDOs, where LIBOR's disappearance could mean that underlying securities revert to a LIBOR fallback while the replacement for LIBOR (if any) in the loans underlying those securities remains uncertain, creating a mismatch.

4. US regulators are expecting action – it's not clear what kind.

In July, just after our last LinkWrap was released, the Securities and Exchange Commission published its first-ever staff statement on LIBOR transition. In the press release announcing the statement, SEC Chair Clayton said, "The SEC will continue to monitor disclosure and risk management efforts related to the LIBOR transition, and we welcome engagement from market participants on these important matters." (Friedman Kaplan wrote an article about what it means for investment management firms for *Hedge Fund Law Report*.)

In July, FHFA head Mark Calabria told Reuters that "We have not yet told Fannie and Freddie to stop buying LIBOR ARMs, but that is a day that will come." And sure enough it did: at the end of September, the FHFA announced in a Supervisory Letter that Federal Home Loan Banks "should, by March 31, 2020, no longer enter into new financial assets, liabilities, and derivatives that reference LIBOR and mature after December 31, 2021 for all product types except investments." FHLBs are also required to report on LIBOR exposures extending past the end of 2021, and how they intend to risk-manage such positions.

And now, 'tis the season for regulators to announce their regulatory and enforcement priorities for 2020. Not surprisingly, LIBOR is on many regulators' lists. First out of the gate was the Office of the Comptroller of the Currency, which included in its supervisory strategies for FY 2020 focus "preparation for the potential phase-out of the London Interbank Offering Rate (LIBOR)." (Note how the OCC refers to the "potential" phase-out.) Other regulators such as the SEC, the CFTC and FINRA usually publish their priorities in mid-December, so look out for those to include LIBOR transition.

5. "Tough legacy" transactions are a significant concern for financial stability.

Perhaps the most significant challenge to LIBOR transition that has emerged over the last six months is what have come to be known as "tough legacy" transactions. This term refers to existing transactions – particularly those created before Andrew Bailey's July 2017 announcement – that lack robust (and in some cases any) LIBOR fallback language and also are not easily susceptible of being amended. Difficulty in amending may stem from a both practical issues such as unanimous consent requirements and political considerations such as

the need to treat retail market participants such as residential ARM borrowers with extreme care. The tough legacy category includes many floating rate notes and securitizations, as well as consumer products such as student loans and residential mortgages. In August, Fitch Ratings noted the continuing challenge of tough legacy transactions in fixed-income markets: "Even if there is a universal determination of a LIBOR-replacement index, the mechanics of changing the older deal documents are daunting …[T]he LIBOR transition could present logistical challenges especially for legacy transactions that represent a significant portion of outstanding issuance. As such, the investor consent aspect raised by the trustees remains a key concern."

By way of example, in January 2019, *Barron's* reported on a series of perpetual preferred securities issued by Citibank with fallback language that reverted to a fixed rated based on where LIBOR was set when those securities were issued in 2010. Every quarter since then, Citibank's Fixed Income Investor Review conference call has mentioned the "the unique language in the subset of our preferred securities," and noted the bank is "continuing to evaluate alternatives, including a potential exchange or amendment" and "still working through additional considerations." Interestingly, over the summer, Citigroup's Jeanine Hyman, as chair of the ARRC Accounting and Tax Subgroup, wrote to the Chief Accountant at the SEC about this issue. We will keep watching this situation to see what Citibank comes up with.

While regulators can encourage (if not force) market participants to stop entering into new LIBOR-based transactions, they cannot force parties to a contract to change it if they cannot or do not want to change it. For this reason, in the US, the ARRC has focused on possible legislative remedies at the state level (in New York) and the federal level. The remedy that has been suggested is a statute that would declare that using a specified alternative to LIBOR (perhaps including a specified spread adjustment) would be deemed to constitute substantial performance of a contractual obligation to use LIBOR. So far, the ARRC's effort on this issue has not produced any specific results or even a proposal or consultation. (Earlier this year, Friedman Kaplan wrote an article for *Law360* about this issue and identified some of the major impediments.)

What should market participants be doing right now?

In our last LinkWrap, we listed a number of considerations for market participants in primary LIBOR-based markets. In this edition, we suggest some different considerations that may apply to investors that buy, sell or invest in LIBOR-based instruments in secondary markets, where there generally is no opportunity for an individual buyer or seller to shape the terms of the transaction.

For newly acquired LIBOR-based positions:

- Implement risk-management procedures to make sure new LIBOR-based positions are added with full awareness of their terms and risks, including how they will operate in the event of LIBOR cessation and whether they can be amended (with or without a holder's consent).
- Consider whether or when to set limits on the acquisition of new LIBOR-based positions.

For existing LIBOR-based positions:

- Inventory LIBOR-based positions and analyze them in light of historic portfolio turnover data to determine which ones are most likely to remain in the portfolio at the end of 2021.

- Use a risk-based approach to determine which positions are likely to be affected by LIBOR transition, whether because they are likely to remain in the portfolio at the end of 2021 or because pre-2021 LIBOR transition impacts may affect their valuation, pricing, modeling or other characteristics.
- For those LIBOR-based positions that are likely to remain in the portfolio at the end of 2021:
    - Find all documents and analyze them for provisions regarding LIBOR use, LIBOR fallbacks, amendments, etc.
    - Develop a plan to:
        - Initiate, respond to, and track on efforts to amend LIBOR-use provisions and/or old fallbacks, and
        - Operationalize LIBOR fallbacks so they are administered correctly when the time comes.
- For those LIBOR-based positions that may be affected in terms of valuation, pricing, modeling or other characteristics, develop plans to, among other things:
    - Update valuation and pricing methodologies and procedures, and
    - Update models to incorporate LIBOR alternatives (including for discounting, etc.).

<u>For operations and compliance:</u>

- Identify systems that need to be updated to use non-LIBOR rates such as for discounting, interest computations, modeling and treasury management and develop a plan for updating them
- Develop a plan to respond to regulators' inquiries about LIBOR transition planning including plans to revise and update:
    - Risk and other disclosures – to explain risks related to LIBOR transition
    - Valuation procedures – to account for possible valuation impacts of weak or nonexistent LIBOR fallback provisions
    - Policies and procedures for approving new LIBOR-based positions

How Friedman Kaplan Can Help

Friedman Kaplan's LIBOR Transition Task Force is ready to:

- Help clients understand the legal, compliance, business and operations implications of LIBOR transition
- Develop potential strategies to address LIBOR-related exposures in advance of the 12/31/21 deadline
- Identify, mitigate and, where appropriate, litigate disputes arising from LIBOR-transition-related activities and issues