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Spring 2020 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 four major themes:

1. The impact of the COVID-19 crisis has not changed the FCA's plans to cease compelling submissions to USD LIBOR as of December 31, 2021, although some intermediate milestones are likely to move (and some have moved already). Some market participants believe that LIBOR's behavior during the crisis has only confirmed the need to replace it.

As of this writing, the message from key regulators is unwavering: USD LIBOR will cease to be available at the end of 2021. In January, the FCA wrote to ISDA emphasizing that the end-2021 deadline is firm, and that any period of "non representative" LIBOR publication would be "a short period (i.e., a period of months, not years)."

On March 25, the UK FCA issued a statement on "Impact of the coronavirus on firms' LIBOR transition plans":

> **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. The transition from LIBOR remains an essential task that will strengthen the global financial system. Many preparations for transition will be able to continue. There has, however, been an impact on the timing of some aspects of the transition programmes of many firms. Particularly in segments of the UK market that have made less progress in transition and are therefore still more reliant on LIBOR, such as the loan market, it is likely to affect some of the interim transition milestones.**

Alongside other international authorities, the Bank of England, FCA and Working Group will continue to monitor and assess the impact on transition timelines, and will update the market as soon as possible.

The FCA also has published its business plan for 2020/2021, which includes "Orderly transition from LIBOR" as a "key outcome" for the wholesale financial markets: "We are supporting the transition to alternative risk- free rates to increase market integrity through our policy and supervision work. It is important that firms transition before the prospective end of LIBOR after the end of 2021 and treat customers fairly." Still earlier, the ARRC's March 20 (telephonic) meeting minutes state that "there has been no change to the existing timeline for the LIBOR transition. Chair Tom Wipf "noted that it is important for the Committee to strike a balance to keep work underway the best we can while being respectful of the time and the situation."

Early in April, the FSB also stated "The transition from LIBOR remains a priority as firms cannot rely on LIBOR being produced after end 2021," and reminded market participants that the purpose of the transition is to "help to strengthen the global financial system." In mid-April, FSB Chair Randal Quarles wrote to G20 Finance Ministers and Central Bank Governors that "FSB work on benchmark transition remains a priority for the G20 Presidency and the FSB" and promised "a report to the G20 Finance Ministers and Central Bank Governors on supervisory measures being taken, and remaining challenges to benchmark transition in July, and … ways to address them."

A number of market participants and commentators have opined that LIBOR's behavior during the COVID-19 crisis has only further demonstrated the need to transition to a new benchmark. In its May 2020 Interim Financial Stability Report, the Bank of England also reports that "During March, the limited market transactions underpinning these [LIBOR] benchmarks fell away, leaving them almost entirely reliant on expert judgement." Nonetheless, there have been reports of market participants pausing or postponing LIBOR transition work during the crisis.

2. The official sector continues to work on measures to facilitate the transition away from LIBOR.

Consistent with the messages from LIBOR's regulator the UK FCA, official sector and industry groups both in the US and the UK continue to move ahead with transition work:

- Several regulators, including the SEC, FINRA, and NCUA have announced supervisory or enforcement priorities for 2020 which include LIBOR transition. (The CFTC has not announced its 2020 enforcement priorities as of this writing.)

- In late 2019, BlackRock identified LIBOR transition as one of the key areas in the "financial ecosystem" that need consideration by financial regulators to further strengthen stability.

- In January, the UK regulators published a set of documents setting LIBOR- transition priorities and milestones for 2020, including a deadline of Q3 2020 to end issuance of GBP LIBOR-linked cash products.

- A few weeks later, it was reported that the ARRC planned to follow the lead of the UK regulators in setting interim deadlines/milestones for LIBOR transition. That has so far not come to pass, likely due in significant part to the COVID-19 crisis, which has slowed even the UK's relatively smooth progress.

- On January 31, the ARRC published a checklist for buy-side market participants, outlining key areas where action is needed. At the same time, the ARRC also published a vendor survey to be used as a self-assessment tool for software and technology vendors to assess their own readiness.

- On February 27, the UK FCA sent asset management firms a "Dear CEO" letter to set expectations regarding their LIBOR transition plans. No formal response is required.

- On March 2, the New York Fed began publishing official SOFR averages and a SOFR Index.

- On March 6, the ARRC published long-awaited details of its proposed New York legislation for USD LIBOR contracts.

- On March 11, the UK FCA (LIBOR's official regulator) issued an announcement detailing how it plans to advise market participants of action that trips pre- cessation fallback triggers.

- On March 12, FASB issued Update 2020-04 to provide "optional expedients that reduce costs and complexity of accounting for" contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued.

- When the New York Department of Financial Services announced a slate of COVID-19 regulatory relief measures on March 12, it notably did not further extend the March 23 deadline for regulated firms to report to DFS on their LIBOR-transition plans.

- In early April, Australian regulators published a summary of responses to their May 2019 "Dear CEO" letters, and the ARRC published its final recommendation for a spread adjustment methodology for cash market transactions after a consultation it had launched in January. A few weeks later, the ARRC issued a further consultation on certain technical details of the spread adjustment methodology.

- On April 15, ISDA announced the results of its consultation on pre-cessation triggers (although the response deadline had twice been extended from the original March 6 deadline to March 25 and then to April 1).

- The ARRC also published a consultation on LIBOR fallback language for new variable-rate student loans, with comments due May 15. (This consultation came not long after several industry groups had written to the ARRC about their concerns about the potential impact of LIBOR transition on student loan borrowers.)

- On April 22, Bloomberg, which has been selected by ISDA as the vendor to calculate and distribute risk-free rate adjustments for swaps, published its inaugural rule book.

- On May 6, the ARRC issued guidance on the use of the SOFR Index with floating rate notes.

- The following day, on May 7, the ARRC published a summary of the results of its January 2020 vendor survey and also announced it is finalizing a set of "best practices," including "sunset" dates after which no new LIBOR-based activity should be conducted. It also announced the following "vendor readiness dates" to facilitate these sunsets:
    - Floating rate notes: no later than June 30, 2020
    - Business loans: no later than September 30, 2020
    - Consumer loans: no later than September 30, 2020
    - Securitizations: no later than December 31, 2020

While most official sector organizations are indeed "full speed ahead," some have tapped the brakes. On March 16, the FHFA announced it was extending from March 31, 2020 to June 30, 2020 the deadline for the Federal Home Loan Banks to cease entering into LIBOR-based instruments maturing after December 31, 2021 (with certain exceptions). On April 29, the UK FCA, the Bank of England and the Risk-Free Rates Working Group formally announced the extension of interim deadlines for the transition away from Sterling LIBOR due to the impact of COVID-19. On May 7, the Bank of England announced it was extending the date after which it will impose increasingly large haircuts on LIBOR-linked collateral from the end of September 2020 to April 2021.

3. Use of SOFR, the ARRC's recommended replacement rate, continues to grow modestly, but also continues to meet resistance from some market participants. Alternatives to SOFR are gaining traction, particularly among smaller banks.

In February, ISDA published the results of a study of adoption of risk-free rates, which showed glacial progress for SOFR.

On February 26, the heads of ten mid-size U.S. banks wrote to the Fed, the FDIC and the OCC to object to SOFR as a one-size-fits-all replacement for LIBOR and expressing support for AMERIBOR as more appropriate for their needs. On May 4, Signature Bank president Scott Shay published an op-ed in *American Banker* strongly criticizing SOFR and arguing that through the ARRC's proposed New York State legislation, "Megabank lobbyists are misleading New York lawmakers by claiming there is no controversy," and that the proposal should not be "an opportunity for the megabanks to impose their will and gain with another oligopoly on the rest of the nation's banks and businesses."

In an effort to advance the use of SOFR, the Federal Reserve Board initially directed lenders under the CARES Act's Main Street Lending Program to price their loans using SOFR rather than LIBOR. That met with significant resistance from both large and small banks, which cited operational obstacles, and the Fed ultimately relented. Friedman Kaplan's Anne Beaumont commented (*Wall Street Journal* subscription required) on this outcome, noting the missed opportunity to have banks that were capable of using SOFR test-drive their systems on MSLP loans and to avoid adding more LIBOR-linked "rocks" to the "pile" of instruments requiring attention when LIBOR ends. In the wake of the Fed's decision, one market participant noted that the situation highlighted the shortcomings of both SOFR and LIBOR, namely that "SOFR alone would be a terrible lending index, [while] LIBOR is terrible because it acts in a dysfunctional way because nothing trades in it. What used to be good isn't really working and what's supposed to be replacing it isn't really working."

On May 7, ICE published a new fourth update on its ICE Bank Yield Index, with new information about the index's performance during the COVID-19 crisis.

Meanwhile, asset managers also continue to struggle with various aspects of LIBOR transition, including (*Pensions & Investments* subscription required) the lack of supply of SOFR-linked transactions in the face of regulatory pressure to cut or cease LIBOR-linked investments.

4. "Tough legacy" transactions remain a significant concern for financial stability. The ARRC's proposed legislative solution for such transactions may be a casualty of the COVID-19 crisis.

Contracts with no or inadequate LIBOR fallback language continue to pose a significant challenge for market participants. A recent study determined that less than 60% of loan and bond contracts referencing LIBOR had specific language outlining what rate to use when LIBOR ceases to become available, and half of those contracts that do have fallback language would effectively default to a fixed rate.

As noted above, in early March, the ARRC published its proposed New York legislation for USD LIBOR contracts. Even before that, the ARRC had reported in its January meeting minutes that it had engaged with the New York Governor's Office and also was discussing the "need for legislative affairs experts that could help educate New York State authorities" about LIBOR transition.

When the proposed legislation was finally unveiled, there already were doubts about whether such legislation practicably could be enacted (and perhaps survive a constitutional challenge) sufficiently before the end of 2021 so as to provide certainty to market participants. Any momentum the ARRC had hoped to build was stopped in its tracks almost immediately by the COVID-19 crisis.

Meanwhile, in early February, Federal Reserve chair Jerome Powell told (*Law360* subscription required) lawmakers that there is no need for federal legislation to address LIBOR transition.

Meanwhile, in a mini-preview of things to come upon LIBOR cessation, as of March 20, the ICE Swap Rate, a daily measure of term IBOR-referencing swap rates has not published any scheduled fixings in that month. It appears there have been no fixings since then, and as a result, desks pricing and settling trades requiring the ICE Swap Rate must resort to dealer polling or use the last available rate, which was from February 27.

Lastly, as in prior LinkWraps, we check in on the quarterly Citibank Fixed Income Conference Call to see if Citi has come up with a solution to address the problematic LIBOR fallback language in some of its permanent preferreds, which *Barron's* first identified in January 2019. The short answer: there isn't.

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
- Advise clients in connection with new and existing lending and other business agreements referencing LIBOR to ensure they include appropriate provisions, including fallbacks
- Help clients identify "tough legacy" transactions and agreements and determine which ones may require priority attention regardless of whether resources for LIBOR transition are reduced or temporarily unavailable due to the COVID-19 crisis
- Identify, mitigate and, where appropriate, litigate disputes arising from LIBOR-transition-related activities and issues