

# **Bond Case Briefs**

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## **LIBOR Summer Update: Regulatory Scrutiny Heats Up on Transition Preparedness - Sherman & Sterling**

With fewer than 18 months until the expected cessation of the London Interbank Offered Rate (LIBOR), regulators have developed a keen interest on how financial institutions are preparing to transition from what has been called the “world’s most important number.” In recent weeks, a number of U.S. and global regulators have issued statements on the need for financial institutions to make actionable progress. On July 13, 2020, John C. Williams, President of the Federal Reserve Bank of New York, said “the importance of transitioning from LIBOR is so great that despite the effects of the COVID-19 pandemic, the overall timeline remains the same.”[1] Notably, the transition was the focus of his first speech since the advent of the pandemic on a topic other than economic and monetary policy. Emphasizing the need for the market to “work together to ensure we are all ready for January 1, 2022,” Mr. Williams stressed that “[i]t doesn’t matter whether you’re a large global bank or a local company with a handful of employees, you need to be prepared to manage your institution’s transition away from LIBOR.”

In this memorandum, we summarize some of the more recent statements by regulatory authorities on the LIBOR transition.

### **Global Regulatory Bodies Urge Action**

The LIBOR transition has been called an “essential task” by the Financial Stability Board (FSB), and one that is directly related to global financial stability.[2] With the transition having been identified as a G20 priority, the FSB has joined the Basel Committee on Banking Supervision in issuing a report that identifies several remaining supervisory and other challenges to the transition, based on surveys taken by the FSB, the Basel Committee and the International Association of Insurance Supervisors.[3]

Among other findings, the report noted:

- Authorities are expecting financial institutions to make “significant progress” in 2020.
- From a microprudential perspective, the key concerns related to the LIBOR transition are in terms of operational risks; legal risks; prudential risks; conduct, litigation and reputational risks; hedging risks; and accounting risks.
- From a system-wide perspective, the uncertainty about the future of LIBOR as we get closer to the end of 2021 could increase macroprudential risks from heightened volatility or disorderly markets, as users are unable, unaware or unwilling to move to the new benchmarks.
- Challenges relating to contract amendments and the lack of term rates for risk-free rates (RFRs) are widely cited as the main obstacles to a successful transition for financial institutions.
- Lack of liquidity in new RFR products and the uncertainty of when sufficient liquidity will be achieved make it difficult to motivate market participants to shift to RFRs.
- For derivative contracts, financial institutions are awaiting the finalization of the ISDA fallback language and largely plan to adopt the ISDA protocol for the alternative reference rates. For cash products, authorities in many jurisdictions have raised concerns about the complexity of

incorporating robust/standardized fallbacks into legacy contracts that do not have them, and the required operational readiness to facilitate their use.

- Authorities are concerned about the differing supervisory expectations for transition across jurisdictions, especially on legal and conduct risks. The varying transition timelines for different products is complicating the monitoring. There is a lack of clarity regarding the readiness of external systems used by financial institutions and others. Supervisors also have limited insight into, and communication with, the non-regulated clients of regulated financial institutions.
- Authorities have identified number of available tools of increasing supervisory intensity to speed up transition in case the increased monitoring and scrutiny do not prove sufficient. In the first stage these would include meetings with banks' senior management, board of directors and the issuance of non-binding best practices. More intensive measures may include on-site inspections and requests to improve operational capabilities (e.g., risk-mitigation plans, requirements to increase resources aimed at supporting transition). In exceptional circumstances, some jurisdictions pointed to the use of capital charges and restrictions on specific product offerings, and finally administrative sanctions or other legal actions.

### **US Banking and Consumer Regulators Ramping Up LIBOR Transition Focus**

On July 1, 2020, the Federal Financial Institutions Examination Council (FFIEC) issued a statement highlighting the financial, legal, operational and consumer protection risks that financial institutions will need to address as they prepare to transition away from LIBOR.[4] The discontinuation of LIBOR will affect nearly every financial institution, though larger institutions and those engaged materially in capital markets activities will face a more substantial impact.

The FFIEC's statement does not constitute new guidance, nor it is a regulation, but it suggests an increasing emphasis within the bank examiner community that the LIBOR transition needs to be properly planned for and prioritized.

According to the FFIEC's statement, institutions should first identify risks in their own on- and off-balance sheet assets and contracts that reference LIBOR, including derivatives, commercial and retail loans, investment securities and securitizations. Potential risks include:

- operational difficulty quantifying the exposure;
- financial, valuation and model risk related to reference rate transition;
- inadequate risk-management processes and controls to support the transition;
- consumer protection-related risks;
- limited ability of third-party service providers to support operation changes; and
- potential litigation and reputational risk arising from reference rate transition.

Following an identification of key risks and dependencies, institutions should quantify their LIBOR exposure. Generally, exposure is measured as the size of any activity and the number of counterparties or consumers with financial contracts that reference LIBOR across all products. This quantification should also include an assessment of the viability of existing contract fallback language. For contracts with inadequate fallback language, institutions need to develop a remediation strategy. To limit additional exposure, institutions should also discontinue the origination or purchase of LIBOR-indexed instruments.[5] For derivatives exposures, the FFIEC recommends that financial institutions and their clients eventually adhere to the International Swaps and Derivatives Association's protocol upon its release.

In planning for the transition, institutions should consider the various legal, operational and other risks associated with various consumer financial products that reference LIBOR. Any replacement rate not already included in fallback language may impact consumers, increase reputation risk and

result in legal exposure to institutions and the financial industry. Transition plans should, among other things, identify affected consumer loan contracts, highlight necessary risk mitigation efforts and address development of clear and timely consumer disclosures regarding changes in terms.

Relationships with third-party service providers is another key aspect of sound transition planning. When addressing third-party service providers that use LIBOR to provide valuation/pricing, modeling, accounting or other services, institutions should evaluate the preparedness and transition planning of those providers and consider whether they will be able to accommodate an alternative reference rate.

Significantly, the FFIEC has indicated that “the supervisory focus on evaluating institutions’ preparedness for LIBOR’s discontinuation will increase during 2020 and 2021, particularly for institutions with significant LIBOR exposure or less-developed transition processes.” Looking ahead, supervisory staff will ask institutions about their exposures to LIBOR-indexed instruments and details on their specific plans to transition away from LIBOR during regularly scheduled examinations and monitoring activities. In particular, the FFIEC identified the following areas as points for discussion with supervisory staff:

- identification and quantification of LIBOR exposure across product categories and lines of business;
- risk assessment of LIBOR exposures, which may include scenario testing, legal review and other analysis;
- transition plans with milestones and key completion dates addressing areas such as:
- strategies to inventory, analyze and assess risk posed by existing contracts;
- strategies to identify replacement rates, modify spreads and revise existing contracts, as necessary;
- strategies to address third-party risk management;
- potential impact to the institution’s customers;
- communication plans for engaging with customers and other stakeholders; and
- plans to identify, monitor and resolve system and other operational constraints;
- management’s assessment of revisions that may be necessary to update the institution’s policies, processes and internal control systems;
- responsibility for LIBOR transition oversight (to a committee, team or officer); and
- progress reporting to a supervised institution’s board of directors and senior management on the LIBOR transition plan.

While there is a recognition that the supervisory focus itself will depend on the size and complexity of each institution’s LIBOR exposures, examiners expect “[a]ll institutions” to have transition plans and risk management processes in place.

## **SEC Eyes LIBOR Preparedness of Registrants**

On June 18, 2020, the Securities Exchange Commission’s (SEC) Office of Compliance Inspections and Examinations announced the details of an examination initiative specifically focused on the LIBOR preparedness of firms on the “buy-side” of LIBOR-based products: SEC-registered investment advisers, broker-dealers, investment companies, municipal advisers, transfer agents and clearing agencies.[6] The announcement was accompanied by a sample document request that included items ranging from the assessments and plans undertaken to date, the identity of third parties that have been engaged to assist with the transition and materials referencing the LIBOR transition that have been provided to a registrant’s board of directors. We have summarized the SEC’s release in our [memorandum](#) of July 20, 2020.

## Next Steps

Financial institutions of all kinds need to take recent statements by regulators seriously. Indeed, many financial institutions have already designed transition-related infrastructure and formulated plans. But having plans is not the same as actually executing them. There needs to be a full understanding of how to properly mitigate the various legal and other risks that arise from such tasks as executing contract amendments, communicating with customers and counterparties and responding to inquiries from regulators.

## Footnotes

[1] John C. Williams, President and Chief Executive Officer, Federal Reserve Bank of New York, "[537 Days: Time Is Still Ticking](#)" (July 13, 2020).

[2] FSB, "[FSB Statement on the Impact of COVID-19 on Global Benchmark Reform](#)" (July 1, 2020).

[3] FSB and the Basel Committee on Banking Supervision, "[Supervisory Issues Associated with Benchmark Transition: Report to the G20](#)" (July 9, 2020).

[4] FFIEC, "[Joint Statement on Managing the LIBOR Transition](#)" (July 1, 2020). The FFIEC is composed of the principals of the following: the Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the State Liaison Committee and the Consumer Financial Protection Bureau. Various agencies with representatives on the FFIEC have made separate statements indicating that the LIBOR transition is a key supervisory priority for 2020 and 2021.

[5] The U.S. Alternative Reference Rates Committee (ARRC) has recently issued a set of "recommended best practices," which contained specific timelines for a variety of products. According to the ARRC, USD LIBOR should not be used in new transactions, with timing varying on the particular product: for floating rate notes, by December 31, 2020; for business loans, by June 30, 2021; for mortgages, by September 30, 2021; for securitizations other than CLOs, by June 30, 2021, and for CLOs by September 31, 2021; and for derivatives, by June 30, 2021. See "[ARRC Recommended Best Practices for Completing the Transition from LIBOR](#)" (May 27, 2020).

[6] SEC, "[Examination Initiative: LIBOR Transition Preparedness](#)" (June 18, 2020).

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