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Signals or Noise in November for LIBOR Transition? - McGuire Woods

Several remarks and releases by public officials and significant regulatory bodies in the first weeks of November garnered significant attention by financial institutions trying to discern next steps in the wind-down of USD LIBOR.

Fed Support for Synthetic USD LIBOR?

First, at a November 10 Senate Banking Committee hearing, Federal Reserve Board Governor Randal K. Quarles, who also serves as the Board's Vice Chair for Supervision, answered questions from legislators about how the Federal Reserve plans to address so-called "legacy" LIBOR-based contracts that are not due to mature until after the end of 2021, which is the presumptive end date for the publication of LIBOR by the ICE Benchmark Administration ("IBA").

In particular, in response to a question from Senator Toomey (R-PA), Governor Quarles explained that the Federal Reserve was working on "a mechanism that would allow those so-called legacy contracts, the great bulk of them, to mature on their existing basis without having to be re-negotiated and shifted to a new rate." He added that the Federal Reserve had been discussing such a "mechanism" with private banks, UK regulators, and the Financial Stability Board, an international body that monitors and makes recommendations about the global financial system. Governor Quarles did not reveal anything about the mechanism itself, however, other than to say that a "variety" of options were being considered. Our informal rendition of his exchange with Sen. Toomey, from the hearing video, is in the margin.[1]

Two days later, in testimony before the House Financial Services Committee, Governor Quarles gave a similar answer in response to questions from Rep. Patrick McHenry (R-NC), namely that that the Federal Reserve was working on "a way to allow those legacy contracts to … mature on their existing terms," and that it expected to "publicly define the way forward to address that" within the next few months. Governor Quarles added that while legislation might "ultimately" be required to deal with legacy contracts, the Fed at the moment was trying to "allow those contracts to mature before we have a legislative solution for the so-called hard tail.[2]

Finally, at the same House hearing, Governor Quarles agreed with Rep. Brad Sherman (D-CA) that there would be "significant disruption" if there is "no solution at all … when LIBOR stops." But he repeated his belief that "there is a way that we can 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."[3]

Those comments sound a bit like the notion of "synthetic LIBOR", which was advanced a few years ago by the UK Financial Conduct Authority ("FCA") as a way to deal with Sterling LIBOR in difficult-to-transition holdover contracts – essentially establishing a credit spread over a substitute rate (SONIA in the case of Sterling) published on the same "screen" as Sterling LIBOR (such that contract references to the IBA screen for Sterling LIBOR would land on SONIA + a margin). The

FCA has pushed forward with this idea to clean up and deal with laggard contracts, and under legislation currently pending in the UK, the FCA would have broad authority to implement synthetic LIBOR as the fix for Sterling LIBOR contracts.

This works for Sterling LIBOR because its successor (SONIA) has a well-established forward swaps market (over half of the $18 trillion notional value of Sterling swaps in the first half of 2020 were SONIA linked), but would have significant obstacles for US Dollar LIBOR, with less than 1% of the $63 trillion in US Dollar forward swaps traded in the same period linked to SOFR (the presumptive USD LIBOR successor). Given that problem, market participants spent the week or so following his comments wondering what sort of Fed remedy those comments implied.

Not surprisingly, that was one of the first questions put to David Bowman, Sr. Advisor to the Board of Governors of the Federal Reserve, in the November 20 ARRC "office hours". He (appropriately) declined to read those tea leaves for the call participants.

Legislative Solution Back in the Foreground?

Fed Governor Quarles' comments on LIBOR transition legislation also highlight a recent uptick in activity on a "legislative fix" in the New York State legislature and the US Congress. While buzz around legislative solutions seemed largely dormant for much of the year, ARRC favored legislation was finally introduced in the New York State Senate on October 28, and it has been reported that a similar draft bill is also circulating in Congress. Check back in coming weeks for highlights on the substance of those legislative items.

IBA Consultation

Adding to the noise this past week was the November 18 announcement by the IBA of a consultation on its plan to terminate publication of all LIBOR tenors denominated in Sterling, EURO, Swiss Franc and Yen after December 31, 2021. US Dollar LIBOR was conspicuously absent from this list, which could be read to suggest that the demise of US Dollar LIBOR may not take place concurrently with those other currencies. This was also raised during the November 20 ARRC office hours call and (again appropriately) no speculation as to motive was offered. It should be noted, however, that the IBA have reiterated their warning that market participants should not expect US Dollar LIBOR to continue to be published beyond December 31, 2021.

So do these comments and announcements signal a shift in US Dollar LIBOR transition timing, or potential US Dollar LIBOR remediation options, or both? Or are they just understandable noise in a lengthy, complex and technically difficult process along the currently plotted path? Likely the latter but the timing and substance of US Dollar LIBOR transition continues to evolve.

McGuireWoods is continuing to monitor the evolving developments regarding legacy contracts and other LIBOR-transition subjects.

[1] The exchange with Sen. Toomey begins at about the 48:30 mark at the hearing video:

> Sen. Toomey: "I'm mostly concerned about orphan contracts, those contracts that have existed in some cases for years and extend into the future, and they assume a LIBOR index is available for ongoing payments. What are we going to do about these orphan contracts … [that] don't end until after the date on which we expect LIBOR to no longer be operative?"
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> Gov. Quarles: "I think we need to consider a mechanism that would allow those so-called

legacy contracts, the great bulk of them, to mature on their existing basis without having to be re-negotiated and shifted to a new rate … . I think there are a variety of ways to do that. The banks have been discussing that, we've been discussing it with banks. It's an international issue as well [so] we've been discussing it through the F[inancial] S[tability] B[oard] and directly with the U.K. which has a special responsibility for LIBOR, and that within the next month or two we should have a plan to share to address that."

[2] The exchange with Rep. McHenry begins in the hearing video at about the 51:45 mark.

> Rep. McHenry: "We want a clear understanding of the path forward on LIBOR. … Can you give us some assurance of your process going forward?"
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> Gov. Quarles: "… The issue you raised is an important one from a stability point of view, which is that there are a lot of legacy contracts that currently rely on LIBOR that we need to define a path forward for after the end of 2021. The transition for new contracts is going pretty smoothly. The legacy contract is the big issue there … I think finding a way to allow those legacy contracts to continue for at least some period, to allow the bulk of those legacy contracts to mature on their existing terms without a significant change would probably be the best way forward, and we are working on a method to do that. There are a variety of different ways that one could do that, but I would expect over the next couple of months to be able to publicly define the way forward to address that."
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> Rep. McHenry: "Do you have a legislative request, or a need for legislative action by the Congress?"
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> Gov. Quarles: "I think the ultimate transition will ultimately require a legislative element, but at this point I think the answer would be no because I think what we want to try to do is find a way to allow those contracts to mature before we have a legislative solution for the so-called hard-tail."

[3] The exchange with Rep. Sherman begins in the hearing video at about the 1:15:30 mark.:

> Rep. Sherman: "What would be the consequence of simply not having any regulatory or legislative solution, would this result in a lot of class action lawsuits, etc.?"
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> Gov. Quarles: "If there were no solution at all, yes, when LIBOR stops there'd be significant disruption. I think there is a way that we can 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."

By Donald A. Ensing, Susan Rodriguez, Jennifer J. Kafcas & Joseph J. Reilly on November 25, 2020