STRATEGIC INSIGHT

VINING SPARKS

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Transitioning from LIBOR—Latest Developments and Planning Steps

- The transition away from LIBOR is building momentum as we move closer to the assumed 2021 deadline.
- The ARRC recently issued a consultation and is requesting feedback on its proposal to calculate the difference between LIBOR and its successor index (SOFR).
- Feedback to the ARRC must be received by March 6, 2020.
- Your efforts for the transition should be well underway including inventorying all LIBOR exposure, reviewing new and existing contracts (loans, securities, deposits and wholesale funding) for maturity dates and for language that describes what happens if LIBOR ceases to be published or is no longer deemed a reliable index.
- Expect your transition efforts to be subject to increased regulatory scrutiny in the coming months.

Background

In July 2017, the Financial Conduct Authority announced that the world's most important financial index, LIBOR, would continue to be provided as a financial benchmark only through the end of 2021. While the news about LIBOR may have come as a surprise to some, the work to phase out LIBOR in the U.S. began in late 2014 after it became apparent that a systemic decline in actual transactions in the unsecured interbank lending markets made LIBOR unreliable and susceptible to market manipulation. In response to recommendations made by the Financial Stability Board and the Financial Stability Oversight Council (FSOC) to address risks associated with LIBOR, the Federal Reserve convened a group called the Alternative Reference Rates Committee (ARRC).

The ARRC includes private-market participants and others working to develop a replacement for USD LIBOR. The FSOC recognized many obstacles and issues that the ARRC must consider, including:

- USD LIBOR is widely used in US financial markets to set interest rates on home loans, student loans, floating rate corporate loans, many bank loans and other financial products.
- USD LIBOR is widely used as a benchmark and valuation rate for interest rate derivative transactions.
- The replacement for LIBOR must be sufficiently liquid to support its role as a key benchmark.
- The volume of outstanding trades referencing LIBOR and its replacement must be considered. That means a liquid market for hedging basis risk between the existing rate and the new rate is necessary before transition begins.
- Serious consideration must be given to the transition of legacy trades (both cash and derivative transactions). Switching the reference rate for legacy trades will likely impact valuations and other pricing issues.

Latest Developments—Spread Adjustment

As part of the transition away from LIBOR, ARRC has recommended fallback language for cash products that it believes will minimize market disruption when LIBOR ceases to be a reliable index. The recommended fallback language includes three key components:

1. **Trigger event** – an event or occurrence that signals the permanent cessation of LIBOR. ARRC's fallback language includes three triggers related to a permanent or indefinite cessation of LIBOR.
2. **Selection of a new index** – The ARRC has recommended SOFR as a replacement for LIBOR.
3. **Spread adjustment** – Since LIBOR is an unsecured rate with several different maturities and SOFR is an overnight, secured rate, a method to adjust for the difference (i.e., spread) is needed.

ARRC spent considerable time evaluating alternative methods for determining the appropriate spread adjustment. On January 21, 2020, the ARRC released ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR.

ARRC's spread consultation, like the International Swaps and Derivatives Association (ISDA) previously issued consultation, uses a static spread (i.e., fixed) that is determined at a point in time upon the occurrence of a trigger event. Both ARRC's and ISDA's spread adjustments rely on a measure of long-run (3.5, 5 or 10-year) historical difference between LIBOR and SOFR-based rates.

In practice, this means that a spread adjustment would be determined by comparing historical LIBOR rates with historical SOFR-based rates based on the remaining tenor of the underlying instrument. For example, a loan with a 1-year remaining maturity would have a different spread adjustment than a loan with a 5-year remaining maturity. In both cases, the spread adjustment would be determined by comparing historical rate data and applying a static (fixed) spread adjustment to the SOFR index.

ARRC's consultation also provides analysis of and questions about the statistical processes used to determine the spread (average, mean, trimmed mean). And lastly, the consultation contemplates a transition period for application of the spread adjustment. The transition periods range from an immediate application of the spread adjustment at the next reset date (consistent with ISDAs recommendation for derivatives) to a 1-year phase in period. The final transition period recommendation may vary based on the underlying product type.

Interested parties have until March 6, 2020 to respond to this consultation.

Previous Developments

The ARRC, ISDA and other major market participants are making significant progress and have recently released these important proposals, recommendations and consultations:

- ARRC has issued a practical implementation **checklist** to help market participants transition away from LIBOR to the Secured Overnight Financing Rate (SOFR). The checklist covers 10 key areas where action is needed for impacted firms to prepare for the transition to SOFR.
- ARRC has issued fallback language recommendations to address risks in contracts referencing LIBOR where standard industry fallback language either assumed a temporary cessation of LIBOR or was ambiguous. The ARRC believes that voluntary adoption of the recommended fallback language in new contracts will minimize market disruption in the event of a permanent cessation of LIBOR. ARRC has published recommended fallback language for the following product types:

  ✓**Bilateral Business Loans**

  ✓**Securitizations**

  ✓**Floating Rate Notes**

  ✓**Syndicated Loans**

- ISDA has issued a consultation and sought input to develop a voluntary amendment protocol to document the path all derivatives will follow to transition away from LIBOR. The protocol will include a trigger event (i.e. an objective event that signals the end of LIBOR), a replacement index (what the new index will be), how the replacement index will be calculated, and a spread adjustment.
- The ARRC has issued a consultation seeking industry input on fallback language for new Adjustable Rate Mortgages using LIBOR as an index. The comment period has ended, and a final consultation is expected shortly.
- Fannie Mae and Freddie Mac have indicated they will create SOFR-based ARM products in line with ARRC recommendations.
- The Financial Accounting Standards Board (FASB) issued proposed guidance to ease the potential burden in accounting for or recognizing the effects of reference rate reform on financial reporting. Essentially, the FASB is proposing that a change in the reference rate from LIBOR to another index would generally be accounted for as a continuation of that contract rather than the creation of a new contract.
- The Federal Housing Finance Agency, regulator of the Federal Home Loan Banks, issued a supervisory letter instructing the banks to (1) stop purchasing investments that reference LIBOR and mature after December 31, 2021 by December 31, 2019 and (2) by March 31, 2020, no longer enter into new financial assets (other than investments), liabilities, and derivatives that reference LIBOR and mature after December 31, 2021.
- The U.S. Department of the Treasury and the IRS have issued proposed regulations providing tax relief related to issues that may arise as a result of the modification of debt, derivative, and other financial contracts from LIBOR-based language to alternative reference rates.

The ARRC set several goals and created a transition timeline to work towards the replacement of LIBOR. As you can see above, the ARRC and others have been busy issuing guidance and recommendations to lead the financial industry through the transition period.

While bankers have been slow to begin pricing loans using SOFR, the rates market continues to make steady progress in establishing both a cash and derivative market for instruments indexed to SOFR. Since SOFR's inception in April 2018, over $73 billion in debt issuance and over $1 trillion notional amount of SOFR based swaps have been transacted. While SOFR debt issuance is currently dominated by government entities, we expect to see more activity from non-governmental entities once ISDA and ARRC make their final recommendations regarding the LIBOR transition.

Summary

Expect regulators and examiners to ramp up their focus on the LIBOR transition at your next exam. If you have not already, you need to closely examine the extent to which you have LIBOR exposure including the source of that exposure (derivatives or cash instruments) and the tenor. For those with derivative exposure, ISDA will provide "voluntary" amended protocols that will control the transition away from LIBOR to an alternative rate. For those with cash instrument exposure (loans, deposits, securities or borrowings), the ARRC will be your primary source of guidance. We recommend that you take appropriate steps now to ensure that you are ready for this major change. So far, the key action items are as follows:

- Review recommended fallback language with legal counsel and incorporate in all new bilateral loan documents to ensure they are consistent with guidance issued by the ARRC.
- Work with legal counsel to develop a roadmap for dealing with fallback language in legacy contracts – particularly securities, loans and deposits indexed to LIBOR.
- Inventory LIBOR based financial instruments, focusing on any with a maturity date after December 31, 2021. Pay close attention to fallback language included in those instruments.
- For those with no existing LIBOR exposure, starting a hedging program or offering products tied to a specific index, carefully consider using an alternative index referencing SOFR, Prime, Fed Funds, or Treasury rates for any new transactions. Products referencing an index other than LIBOR will avoid the spread adjustments addressed in the newly issued consultation.

The transition away from LIBOR is rapidly picking up momentum. Virtually all financial institutions will be impacted. Announcements from the ARRC and ISDA should be closely monitored for application to your specific situation.

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