



SIFMA Insights

Spotlight: Tick Tock, Only 900 Days Until LIBOR's (Potential) End

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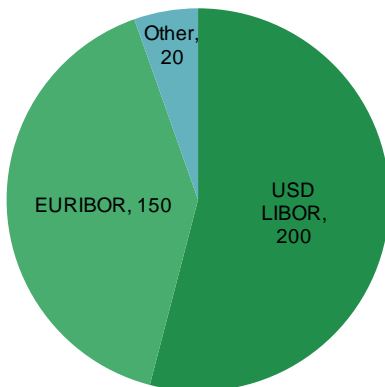
This week SIFMA hosted a LIBOR Transition [Briefing](#), which included remarks from and discussion with Andrew Bailey, CEO U.K. Financial Conduct Authority (FCA) and John Williams, President and CEO Federal Reserve Bank of New York (NY Fed), the co-chairs of the FSB Official Sector Steering Group on interest rate benchmarks. We also heard from Tom Wipf, Vice Chairman of Institutional Securities Morgan Stanley & Chair Alternative Reference Rates Committee (ARRC), along with a panel of ARRC members, including: Nadine Bates, Senior Vice President and Treasurer Fannie Mae; Brian Grabenstein, Head of LIBOR Transition Office Wells Fargo; and Timothy Kitt, Senior Vice President - Head of Pricing and Execution Freddie Mac.

Inside this note we recap thoughts from these key regulators and market participants on the LIBOR transition.

The End Is Nearer Than You Think

LIBOR is important to the functioning of financial markets – referenced globally in derivative, bond and loan documentation; with ~\$200 trillion of total financial contracts tied to USD LIBOR alone – and the transition away from LIBOR, therefore, represents significant risks to markets if firms do not plan ahead. (Please see SIFMA Insights: Secured Overnight Financing Rate (SOFR) [Primer](#) for background on the LIBOR transition.) As noted by the NY Fed's Williams, "there are only 900 days until the end of 2021," at which time markets will no longer have certainty of LIBOR publication, and "he does not always sense urgency among all market participants on this issue." This is a scary statement when one considers what a substantial lift it will be to convert all \$370 trillion in notional exposure to the IBORs, like LIBOR.

IBOR Linked Products (\$T)



Source: ISDA (as of May 2019). Note: Other = GBP LIBOR, JPY LIBOR, CHF LIBOR, EUR LIBOR, TIBOR

This is not to say that no work has begun. It has, and results are becoming clear. For example, in the U.K. in 1H19, Sterling Overnight Index Average (SONIA) represented >45% of all notional swaps trading in sterling, as noted by the FCA's Bailey. Yet, there is much more work to be completed and all speakers/panelists urged market participants to begin working on the transition today, if they have not already. Some legacy contracts will be harder to convert than others. The derivatives markets have developed several options to transition; corporate bond markets are harder, since consent may be needed from 100% of bond holders in some cases. And "loan markets appear to have made the least progress" noted FCA's Bailey, who further went on to acknowledge that firms could face the risk of legal dispute on how to handle legacy contracts (for example, the acting party alone decides how to best perform on an obligation when no arrangement exists for the cessation of LIBOR).

Many questions remain. The only certainty is that there is no certainty. The FCA expects panel bank departures after 2020 (it will not compel banks to continue submitting rates past end-2021), meaning publication of LIBOR may cease. If LIBOR does continue, this rate, which was already based on few transactions, could become even less representative of the underlying market it is meant to characterize. Additionally, it is difficult to imagine that LIBOR – in any form – would be around for the periods covered by some legacy contracts, which are written with decades until maturity, not just a few years.

There will also not be continuity from today's LIBOR: properties and levels of the rates will change, and volatility should increase given the lower level of bank submissions. Further, it opens up the question of whether or not the benchmark will remain compliant with EU regulations (based on the IOSCO [Principles](#) for Financial Benchmarks). The FCA will be forced to test LIBOR to determine if it is representative of the underlying market after panel bank departures, and there is no guarantee the benchmark will pass this test. This will mean EU regulated firms will no longer be allowed to use LIBOR as a benchmark.

Firms need to get moving, as 900 days is not really as long as one might think, at least not in financial services. For example, a panelist indicated updating back office processes at financial institutions can take from 90-180 days, and this is just one step in the transition. Fallback language must be finalized – the ARRC has finalized language for floating rate notes (FRNs), business loans and securitizations, and last week they published a white paper and consultation on fallback language for adjustable-rate mortgages (ARMs). Market participants need to agree on contract changes. Clients must change their mindset to accept SOFR/SONIA linked products. Firms will have to update models and systems accordingly. And this must happen across all types of market participants – remember, the U.S. alone has thousands of banks which need to transition (applies to all regional and community banks, not just large financial institutions), let alone other types of institutions across the globe. Legislation to quicken the transition is being discussed in both the U.S. and U.K., but legislation also takes time to enact and it is not clear that it can address all outstanding issues.

And the clock continues to tick down.

Don't Wait for Term Rates

One reason cited by market participants as to why change has not moved faster is the lack of term rates associated with SOFR/SONIA/etc. Term rates are building blocks for end users of financial products, particularly in some loan

markets. Speakers/panelists indicated term rates are only needed for certain financial products, and, as such, market participants should not be waiting for a full term structure to develop before converting their portfolios. FCA's Bailey pulled no punches hitting on this theme, stating "any firms still delaying transition until term rates arrive are making a mistake."

Regulators indicated the risk free rates themselves, even absent a term structure, should be used to convert legacy contracts and issue new products. The advice from regulators and national working groups like the ARRC have been clear. First, stop writing new contracts tied to LIBOR – every new USD LIBOR contract written "digs a bigger hole." Next, fully assess your firm's LIBOR exposure and ensure appropriate fallback language is in place. To assist with this, the ARRC is working on language for cash products, while ISDA and CCPs are working on derivatives contract language.

Advice from the ARRC on the building blocks for new products includes use of:

1. Overnight SOFR, as developed by the NY Fed
2. Average SOFR, now calculated by market participants with the NY Fed expected to begin publication in 2020
3. Forward looking term SOFR, to be used "at the edges where appropriate"

Contracts should be built on the most robust rates, saving term rates for on the borders. In other words, "don't wait for term rates to get your house in order," says the NY Fed's Williams.

The ARRC also notes all the tools necessary for risk management (fallback language, product structures, etc.) will be completed by the end of 2019. Then the following 6-12 months will be "mission critical" for the transition.

Reference Research and Links

SIFMA Insights: Secured Overnight Financing Rate (SOFR) Primer, the transition away from LIBOR at: <https://www.sifma.org/resources/research/sofr-primer/>

Additional Links:

- ARRC, <https://www.newyorkfed.org/arrc>
- NY Fed on SOFR, <https://apps.newyorkfed.org/markets/autorates/SOFR>
- NY Fed speech at SIFMA event, <https://www.newyorkfed.org/newsevents/speeches/2019/wil190715>
- Bank of England & FCA on SONIA, <https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor>
- FCA speech at SIFMA event, <https://www.fca.org.uk/news/speeches/libor-preparing-end>

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