OPERATIONAL IMPLICATIONS OF DELAYED CESSATION: A LOOK AT USD LIBOR BEYOND 2021

On November 30, 2020, the U.S. LIBOR administrator, ICE Benchmark Administration Limited (or 'IBA'), stated that it intends to consult in early December regarding the possible cessation of: (i) the one week and two-month U.S. LIBOR settings after December 31, 2021; and (ii) all remaining LIBOR rates (e.g., overnight, 12-month) after June 30, 2023[1]. This is a critical development in the LIBOR transition process as it appears that the most used LIBOR settings will continue to be used one and a half years beyond the expected sunset deadline of December 31, 2021.

Capco has been driving LIBOR projects across a number of Tier 1 and Tier II banks, in both the US, and the UK. When the above announcement was made by the ICE Benchmark Administration, most LIBOR programs were already underway with significant momentum. We believe that despite the extended deadline, it is important for banks to maintain this momentum. Most LIBOR programs are large, requiring significant budgets and program management resources, cross-regional (US, EMEA, APAC), and cross-functional, impacting Trading, Risk, Strats and Technology teams. Moreover, the operational changes needed for products with one-week and two-month settings expected to meet the Dec 31, 2021 deadline, will also be required for remaining products which have been moved to the December 31, 2021 deadline. Establishing a successful LIBOR transition program takes several months. We recommend that despite the proposed extension, banks maintain the programmatic and staffing infrastructure they have established around the LIBOR transition, and keep moving forward.

REGULATORY CHANGES AND EXCEPTIONS:

Additionally, on November 30, the Federal Reserve Board, the FDIC and the OCC (together, the 'Regulators') issued a statement encouraging banks to transition from U.S. LIBOR settings as promptly as practicable. The regulators believe that contracts using USD LIBOR beyond December 31, 2021, would create a substantial risk to the financial system's safety and soundness.[2] Indicating that they intended to "examine bank practices accordingly" for any contracts referencing LIBOR after December 31, 2021, the Regulators suggested that any new contracts (before or after December 31, 2021) should either use a reference rate other than LIBOR or have "robust fallback language that includes a clearly defined alternative reference rate after LIBOR's discontinuation."[3]

Nonetheless, the Regulators did acknowledge a narrow series of scenarios when a bank could appropriately enter into new US LIBOR contracts after December 31, 2021, including: (i) transactions executed for purposes of required participation in a central counterparty auction procedure in the case of a member default, including transactions to hedge the resulting USD LIBOR exposure; (ii) market-making in support of client activity related to USD LIBOR transactions executed before January 1, 2022; and

1. See, https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-On-Its-Intention-to-Cease-the-Publication-of-GBP-EUR-CHF-and-JPY-LIBOR/default.aspx
2. See, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf
3. See, https://www.federalreserve.gov/supervisionreg/srletters/SR2027a1.pdf

(iii) transactions that reduce or hedge the bank's or any client of the bank's USD LIBOR exposure on contracts entered into before January 1, 2022.[4]

The Regulators, including the U.K.'s Financial Conduct Authority (the 'FCA'), as well as ISDA, welcomed the IBA release. The regulators noted that it will help a smooth and speedy transition away from contracts referencing USD LIBOR, while making it clear that none of the statements made indicated a cessation of LIBOR and a triggering of the recently-released fallback protocol (i.e., to the adjusted risk-free rate plus spread[5]). The SEC Commissioner, Jay Clayton, agreed stating, "[t]oday's announcements establish a pragmatic, market-oriented path for managing the transition away from LIBOR. We encourage registrants to proactively transition to market-based reference rates and stand ready to assist market participants."[6]

LIBOR Settings	Current Cessation Deadline	Proposed Change
USD LIBOR – 1-Week and 2-Month tenors	December 31, 2021	No change, cessation by December 31, 2021
USD LIBOR – Overnight, 1-, 3-, 6-, and 12-Month tenors	December 31, 2021	Extend until June 30, 2023 for legacy risk
Non-USD LIBOR (GBP, EUR, JPY, CHF) – all tenors	December 31, 2021	No change, cessation by December 31, 2021

INDUSTRY PERSPECTIVE

As news of the proposed delay to June 2023 broke, we reached out to industry leaders to obtain their perspective. Harvey Flax, Director of US Interest Rates Futures Business and Product Development at ICE, advised that a proposed extension does not mean banks should pull the break on implementing the operational and technology changes needed for the move to alternative reference rates.

CAPCO – *With the extension of USD Libor through June 30 2023, should our clients slow down their internal transition planning and processes?*

Harvey Flax – *"No – The US Regulatory Agencies released a Supervisory statement "explaining that the June 30, 2023 cessation date for which IBA is consulting would allow time for "legacy contracts" – USD LIBOR transactions executed before January 1, 2022 – to mature. The guidance further notes that entering into new USD-LIBOR-based contracts creates safety and soundness risks. Given that, the banking agencies encourage banks to stop entering into those new contracts by end-2021"*

CAPCO – *What is the best method for our clients to track the progress of the transition through the listed derivatives market?*

Harvey Flax – *"I would recommend your clients focus on ICE Futures Europe SONIA and SOFR futures daily volumes and Open Interest (OI) – the growth of OI is indicative of liquidity in a futures contract and in this instance, the transition to the replacement indexes.*

Links to ICE Futures:
ICE SONIA Futures
ICE SOFR Futures

4. See, https://www.federalreserve.gov/supervisionreg/srletters/SR2027a1.pdf
5. See, https://www.isda.org/2020/11/30/isda-statement-on-iba-uk-fca-and-federal-reserve-board-announcements-on-us-dollar-libor-consultation/
6. EC.gov | Statement on Developments Related to the LIBOR Transition

IMPACT OF THE EXTENDED LIBOR CESSATION TIMELINE:

- **Orderly Cessation**: Delaying the deadline for Legacy Products, 12-Month, and Overnight Contracts creates an additional 1.5 year buffer for banks to put alternative reference rates in place, and enables an orderly winding down of LIBOR-indexed contracts.

- **Program Management Implications**: Program Managers should note that the deadlines for any products index to 1-Week and 2-Month LIBOR have not changed. This implies that the broader program milestones stay as is, to keep the overall Program on track.

- **Improved Operational Readiness**: While the deadline for legacy LIBOR-indexed products has been delayed, significant operational work still needs to be done around launching new SOFR-indexed products. Specifically, operational teams need to be aware of any internal I.T. builds that may need to be completed before launching the new product, vendor feeds or market risk models that may need to be updated to reflect new risk curves, and systems that need to be prepared to anticipate for significant increases in trading volume. An added advantage of being proactive concerning operational readiness is that many of the process improvement steps that apply to New Products also apply to Legacy Products. Therefore, if a bank has addressed the operational changes needed for a new agency RMBS product, the desk will be prepared for when a legacy product on the same desk moves away from LIBOR.

- **Desk and Operational Staff Training and Preparedness**: As the transition away from LIBOR progresses, Trading Desk, Strats, and Risk Management staff need to be trained on tracking and managing LIBOR exposure, and on how to interpret contract language and Fallback Provisions. The extended timeline allows for additional training and preparedness.

- **Fallback Language and Provisions**: Banks have a significant amount of work left to do in identifying their 'LIBOR exposure inventory' or the subset of products indexed to LIBOR. Data identifying fallback provisions for certain products is not easily available, and banks are using various vendors and techniques to identify exposure and define fallback categories. This includes developing internal OCR and A.I. tools that scan fallback documentation to bucket products and assign fallback categories to them. In many cases, these A.I. and OCR tools are new, and are still being beta-tested and refined. Data vendors, such as Bloomberg are only offering fallback data on cash securities e.g. Bonds. Banks need time to develop and test these tools so they can track LIBOR exposure, and define fallback categories accurately.

- **Negotiation of Fallback Terms (Non-Cash Securities)**: In the case of derivative products, banks' legal teams have to be engaged in negotiating favorable fallback terms with counterparties. Banks have to identify buckets of securities that will need closer legal examination and engage the Legal team with Trading Desk Heads, and Operations, to implement these contracts.

- **Client Communication, Spread Adjustment and Cessation**: Cessation itself comprises of a few different operational steps, which will need to be defined and executed. These include client communication/notification, spread adjustments, etc. It is not a 'one and done' process, and desks need time to wind down positions.

- **Preparing for a LIBOR transition regulatory examination and review**: As Cessation approaches, Risk, Compliance and Operations teams have to be prepared to engage with regulators. The extended deadline allows banks adequate time to prepare their compliance and risk teams for regulatory exams.

ONWARDS TOWARDS ALTERNATIVE REFERENCE RATES

While some banks have begun to revisit LIBOR program milestones and budgets, it is noteworthy that for most large financial institutions, the move away from LIBOR was already in full swing as of mid-2020. The program continued unabated in the midst of the shift to remote work during the Covid-19 pandemic. The majority of LIBOR programs are cross-regional and spread across large swathes of products (Equities, Fixed Income, Listed Products), which are often run by different desk heads, and oversee by a variety of Program Managers. Maintaining momentum in the move towards alternative reference rates, will ensure timely compliance, an orderly winding down of LIBOR-indexed contracts, and operational efficiency.

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