

SPEECH

## Prepare for Landing

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Michael Held, Executive Vice President and General Counsel

### Remarks at the ISDA Benchmark Strategies Forum (delivered via videoconference)

As prepared for delivery

Thank you for that kind introduction, and for the opportunity to speak to you all today. As always, my remarks reflect my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.<sup>1</sup>

It's been almost exactly a year since I last spoke about LIBOR<sup>2</sup> transition.<sup>3</sup> My hope is that I won't be talking about LIBOR again next September because there won't be any need to say more about it. We'll see.

It seems that now, every speech about LIBOR needs some sort of metaphor, so I'm going to compare the transition away from LIBOR to bringing a very large airplane in for a landing. Like a 747 or an Airbus 380. I hope you can all remember what it was like to fly on an airplane—that's something we all used to do in the before times, right? This particular plane has had a very long flight, and the dotted lines on the little electronic map are approaching the destination. I think a lot of market participants have been focusing on U.S. dollar LIBOR's publication ending in June 2023. Now, that may seem to some like a long time away still, and so it's not yet time to make a last pass through the cabin collecting all the stray coffee cups and soda cans. And I don't disagree that June 2023 is an important date; by then, this plane needs to be safely landed and parked at the gate for an on-time arrival.

But I would suggest that 2023 isn't the date you need to be focused on right now. Before you park the plane at the gate, you need to land it, and the landing is the most dangerous part of the flight. By the end of this year—a little over three months away—every firm needs to have stopped using LIBOR for all new exposures, and landed safely on robust alternatives. That's not only a recommendation or best practice, it's explicit supervisory guidance. The good news is that the runway lights are all lit and the landing gear is down. You should be good to go. But there is still the possibility of turbulence, so it's time to make sure your seat belts are firmly fastened and your tray tables are in their upright and locked position.

At the Federal Reserve, our supervisors have been in the control tower watching the plane approach, and the closer it gets to the runway, the closer they're watching it. I want to highlight three things they will be keeping a close eye on in the coming months.

### Headwinds in the Loan Market

One of our main concerns about the transition is a worry that we've had for a while now: inertia in the loan market, especially the syndicated loan market. Lending in alternative rates is not where it should be at this point. As I said, the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have all said that supervised institutions need to stop writing LIBOR contracts of all kinds as soon as practicable, and in any event by the end of this year; that failing to stop by then is a safety and soundness risk; and that they will supervise firms accordingly.<sup>4</sup> Lending banks especially need to move to alternatives, and push their borrowers to move. But in a survey a few months ago, almost two-thirds of nonfinancial borrowers reported that their banks were still not offering them non-LIBOR borrowing alternatives, or even talking to them about what the alternatives might be.<sup>5</sup> That's a problem not just for the banks that don't seem to be moving off of LIBOR, but also for the borrowers who will need time to rework their internal systems and processes before using a new rate. The heads of the US Department of the Treasury (Treasury), the Federal Reserve, the Securities and Exchange Commission (SEC), the New York Fed, and the Commodity Futures Trading Commission (CFTC) have warned of the "considerable operational, technological, accounting, tax, and legal challenges" that the transition from LIBOR presents for Main Street companies.<sup>6</sup> Those challenges will not be solved overnight.

But slow progress in the transition isn't just a concern for the loan markets. Maybe of more interest to the derivatives market, the regulatory guidance has four very specific exceptions to the end-2021 stop date that are related to derivatives. I want to caution you that we intend those exceptions to be read very narrowly, and we are collecting data on LIBOR exposures and alternative rate use from our largest supervised firms so we can make sure firms are on the right course. And firms need to have internal controls in place to ensure that client-facing businesses are following the guidance, especially at and after year-end.

### Coffee, Tea, or SOFR?

A second concern is not about how quickly firms are transitioning, but what rates they are transitioning to. The obvious choice for most purposes is the Secured Overnight Financing Rate (SOFR). It's what the International Swaps and Derivatives Association (ISDA) protocol uses, it's what the Alternative Reference Rates Committee's (ARRC's) fallbacks use, it's what New York State legislation will put in place for LIBOR contracts that don't transition on their own. It's what the proposed federal legislation would use. Following the CFTC Market Risk Advisory Committee's (MRAC's) recommendation,<sup>7</sup> it's what interdealer swap trading



There are lots of resources available to help contracts of every kind transition from LIBOR to SOFR, and lots of real-world examples of how to use SOFR-based rates in new contracts of every type. And just recently the ARRC has endorsed a forward-looking term SOFR for use in contracts that have special problems using other forms of the rate.

SOFR will clearly be the dominant, most robust, most liquid rate going forward. The ARRC has recommended SOFR as the best LIBOR alternative but has no control over your choice to use it or not. And the Federal Reserve has consistently said we are not requiring our supervised firms to move to SOFR in loans.<sup>8</sup> But what the Fed *has* said, along with the OCC and the FDIC, is that alternative rates should be appropriate for the bank's funding model and customer needs.<sup>9</sup> If your firm is moving to a rate other than SOFR, that means extra work for you to make sure you're demonstrably making a responsible decision. Because you are going to be asked about that decision. Vice Chair Quarles has said "Market participants should ensure that they understand how their chosen reference rate is constructed, that they are aware of any fragilities associated with that rate and the markets that underlie it."<sup>10</sup> Acting Comptroller Mike Hsu has said the OCC "expects banks to demonstrate that their LIBOR replacement rates are robust and appropriate for their risk profile, nature of exposures, risk management capabilities, customer and funding needs, and operational capabilities." He said that the OCC supports SOFR as a sound replacement rate, and cautioned that its examiners "will be closely evaluating the robustness of other rates that banks look to use."<sup>11</sup> And Treasury Secretary Yellen<sup>12</sup> and SEC Chair Gensler<sup>13</sup> have both warned that some alternative rates now being used are vulnerable to the same weaknesses as LIBOR.

When it comes to alternative rates, there are special concerns about credit-sensitive rates. The UK Financial Conduct Authority (FCA) has warned its supervised firms that are planning to use credit-sensitive rates to consider the risks carefully and to talk to their FCA supervisor first.<sup>14</sup> The Bank of England has said that credit-sensitive rates are not robust or suitable for widespread use.<sup>15</sup> And just last week, the International Organization of Securities Commissions (IOSCO) itself—the source of the IOSCO Principles on Financial Benchmarks, the baseline for evaluating reference rates—publicly reiterated the importance of transitioning to risk-free rates. IOSCO emphasized that alternative benchmarks must comply with the IOSCO principles at all times. It also cautioned that credit-sensitive rates in particular must be based on active markets with high transaction volumes, must reliably represent their underlying markets, and must be resilient during times of stress. IOSCO echoed regulators' concerns that widespread use of credit-sensitive rates could replicate LIBOR's shortcomings and the related concerns about market integrity, conduct risk, and financial stability.<sup>16</sup>

So, firms need to transition now, while also being extremely careful about what rates they transition to.

### **Fasten Seat Belts**

The third transition issue I want to highlight is fallbacks. The end game set out for the LIBOR transition allows existing legacy U.S. dollar LIBOR linked contracts that mature by the end of June 2023 to roll off. That should cut down significantly on the scale of legacy LIBOR contracts that need to be amended. But for those contracts that do mature after mid-2023, having workable fallback language is essential.

More broadly, Vice Chair Quarles has consistently emphasized that all contracts need strong and effective fallbacks so we don't find ourselves back in the same position in a few years.<sup>17</sup> We're hearing that fallback language in some parts of the market is not as robust or consistent as it should be. And while robust fallbacks are essential no matter what alternative rates a firm decides to use, it's especially important for firms that are using credit-sensitive rates to really do their diligence, to have a full understanding of the rates they choose—including any fragilities in the rate or the markets that underlie it--and to make sure their contracts have solid fallbacks to protect against those fragilities.<sup>18</sup>

### **Federal Law Prohibits Tampering...**

Those are the three issues I wanted to highlight this morning, but before I close I also want to come back to the federal transition legislation I mentioned a few minutes ago. That legislation was passed out of the House Financial Services Committee at the end of July, and we very much hope it will be taken up by the full House and Senate as soon as possible. In its current form, the legislation requires the Federal Reserve Board to engage in rulemaking to transition contracts to a SOFR-based rate if they lack effective fallbacks and the parties have failed to provide voluntarily for a different solution. I very much believe that the legislation in this form is the best solution to so-called "tough legacy" contracts, and I hope the House and Senate pass it into law as quickly as possible so the Board can start the rulemaking process and bring certainty to this part of the transition well ahead of 2023.

### **Happy Landing**

The SOFR transition has been a long flight, and we're getting close to our destination. Now is the time to redouble our efforts to make sure we avoid a bumpy landing, or worse. And don't forget that items in the overhead bins may have shifted during the flight. Thank you for your attention, and I hope we're all back to flying soon.

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<sup>1</sup> Raymond Check assisted in preparing these remarks. Mr. Held would like to thank his other colleagues at the Federal Reserve who provided comments and corrections.

<sup>2</sup> As used in these remarks, "LIBOR" refers to U.S. Dollar LIBOR.

<sup>3</sup> Michael Held, *The LIBOR Countdown Has Not Stopped*, Remarks at the IMN Virtual Investors' Conference on LIBOR, September 29, 2020.

<sup>5</sup> Transition to the Secured Overnight Financing Rate – The Views of Nonfinancial Corporations, Letter from Center for Capital Markets Competitiveness, National Association of Corporate Treasurers and Association for Finance Professionals to Treasury Secretary Yellen, Federal Reserve Board Chairman Powell, New York Fed President Williams, SEC Chairman Gensler, and CFTC Acting Chairman Benham, April 27, 2021 (“Nonfinancial Corporate Stakeholders Letter”).

<sup>6</sup> Response to Nonfinancial Corporate Stakeholders Letter, August 23, 2021.

<sup>7</sup> CFTC’s Interest Rate Benchmark Reform Subcommittee Recommends July 26 for Transitioning Interdealer Swap Market Trading Conventions from LIBOR to SOFR, June 8, 2021.

<sup>8</sup> Federal Financial Institutions Examination Council, Joint Statement on Managing the LIBOR Transition; SR 20-25, Interagency Statement on Reference Rates for Loans, November 6, 2020.

<sup>9</sup> SR 20-27.

<sup>10</sup> Minutes of June 11, 2021 FSOC Meeting.

<sup>11</sup> Written Testimony of Michael Hsu Before the Senate Committee on Banking, Housing, and Urban Affairs, August 3, 2021.

<sup>12</sup> June 11, 2021 FSOC Meeting Minutes.

<sup>13</sup> Gary Gensler, Remarks at London City Week, June 23, 2021.

<sup>14</sup> Edwin Schooling Letter, LIBOR – 6 Months to Go, July 5, 2021.

<sup>15</sup> Bank of England, Financial Stability Report - July 2021.

<sup>16</sup> IOSCO, Statement on Credit Sensitive Rates, September 8, 2021.

<sup>17</sup> Minutes of June 11, 2021 FSOC Meeting.

<sup>18</sup> SR 20-25.

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