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Banks Must Take Libor's End Seriously, Fed's Vice Chair Says

By **Jon Hill**

Law360 (June 3, 2019, 9:27 PM EDT) -- The Federal Reserve's top official for supervision urged banks on Monday to take seriously the impending end of the London Interbank Offered Rate and start preparing for it now, saying the biggest banks can expect to feel more pressure from the agency's examiners to make sure they're ready.

In prerecorded remarks to a New York audience, Fed Vice Chairman Randal Quarles said the financial industry has the tools it needs to begin moving away from Libor, the troubled interest-rate benchmark that trillions of dollars of financial instruments are tied to but that U.K. regulators have pledged to support only through the end of 2021.

Those tools include a suitable alternative benchmark known as the Secured Overnight Financing Rate and model fallback provisions for Libor-tied cash product contracts, but now it's up to the industry to use them, Quarles said.

"With only two and a half years of further guaranteed stability for LIBOR, the transition should begin happening in earnest," Quarles said, according to prepared text of his speech. "Regardless of how you choose to transition, beginning that transition now would be consistent with prudent risk management and the duty that you owe to your shareholders and clients."

Quarles' comments came at a round table co-hosted by the Alternative Reference Rates Committee, a Fed-sponsored group of financial services industry representatives that has spent the past several years laying groundwork for banks, insurers and other financial firms to phase out their use of Libor in favor of SOFR.

The ARRC endorsed SOFR as its preferred alternative rate in 2017, and since then, Quarles said the group has fostered the development of an increasingly liquid market for SOFR derivatives and recommended templates of contractual language so that new Libor-linked issuances will be able to weather Libor's discontinuation with minimal disruption.

The most recent such language was released Friday, when the ARRC came out with finalized fallback provisions for bilateral business loans and securitizations tied to U.S.-dollar Libor. The group has also put out recommended fallbacks for syndicated loans and floating-rate notes, finalizing that language in April.

Quarles said these efforts by the ARRC represent "the most viable path forward" for banks and other financial institutions to move away from Libor in the time remaining until its potential 2021 end, but he said an even easier path might be to stop using Libor altogether.

“At this moment, many seem to take comfort in continuing to use LIBOR — it is familiar, and it remains liquid,” Quarles said. “But history may not view that decision kindly; after LIBOR stops, it may be fairly difficult to explain to those who may ask exactly why it made sense to continue using a rate that you had been clearly informed had such significant risks attached to it.”

Quarles also said that supervisory teams from the Fed have already been asking “detailed questions” of big banks about their plans for the Libor transition. And as 2021 draws nearer, Fed examiners will have greater expectations for preparedness at the banks they supervise, he added.

“Our supervisory approach will continue to be tailored to the size of institution and the complexity of LIBOR exposure, but the largest firms should be prepared to see our expectations for them increase,” Quarles said. “As we consider the answers we have received from these firms, we will assess how our supervisory expectations for them should evolve in the coming year.”

Monday’s speech by Quarles marked the latest uptick in intensity from federal regulators as they seek to rouse the financial services industry to action ahead of Libor’s phaseout, which was announced by the U.K.’s Financial Conduct Authority in 2017 amid mounting concerns about the benchmark’s robustness.

Cadwalader Wickersham & Taft LLP partner Lary Stromfeld, one of three firm partners who advised the ARRC on the drafting of its model fallback language, told Law360 that regulators have previously focused on raising awareness about the looming end to Libor, but this year, they have been increasingly vocal about the need for firms to actually start the transition process.

“The fact that the urgency is being turned up is not a coincidence,” said Stromfeld, who also heads a team at Cadwalader that specializes in advising clients on Libor transition preparedness. “The impediments to acting upon the transition are getting cleared away with the publication of SOFR and the publication of this fallback language.”

Mark Chorazak, another Cadwalader partner and member of the firm’s Libor preparedness team, told Law360 that the Fed appears keen in the near term to see that financial institutions have begun taking reasonable steps to prepare for and manage the transition.

Those firms that haven’t are unlikely at this stage to be hit with anything as drastic as an enforcement action, according to Chorazak, but regulators might instead opt for more informal ways of spurring on laggards, like issuing supervisory warnings known as MRAs, or matters requiring attention.

“Vice Chair Quarles’ words are likely not lost on banks today, and banks that are well-prepared are probably taking heed that this is all the more reason to get policy frameworks and transition plans developed very quickly,” Chorazak said.

--Editing by Amy Rowe.