Transcript for:

FFIEC Industry Outreach: LIBOR and Alternative Reference Rates
DECEMBER 6, 2018
1:00 P.M. ET

Hello and welcome to the FFIEC Industry Outreach webinar. I am Jean Roark from the Federal Reserve and I will be your facilitator. Today we'll discuss LIBOR and Alternative Reference Rates. We are joined by a bunch of agency representatives at the Federal Reserve Board in Washington, D.C. and our speaker today is Cam Fuller from the Federal Reserve. Before turning our call over to Cam, I'll run through our call logistics. If you haven't joined us through the webinar yet go ahead and click the link you received after registering. For the best webinar experience, use the FAQ document, which can be found using the materials button in the webinar player page. I'll highlight a few important notes for you.

Upon entering the webinar, you are automatically set up to stream the audio through your computer speakers. But if you have audio issues, you can dial in through the phone. The connection information is listed in the webinar player page. It's important to note that if you choose to use the phone option, slides will not sync with audio unless you change one setting. You can do this by selecting the grey gear located on the upper right corner of the slide window just above the presentation. From there you should see a few options and the media chooser and you should select the phone option. Now, you only have to adjust the media chooser if you're listening through the phone. If you're streaming through your PC, you are good to go. All right. And you can expand the size of the slides. To do that use the maximize button in the upper right corner of the slide window and if you would like to access a PDF version of today's presentation, you can access it using the materials button. We're also offering closed captioning for today's webinar and to use this function you can select the closed captioning button in the webinar player page.

We will offer a couple of polling questions today too, so use your best listening ears and grab your mouse when we're ready to do that and Cam will prompt me to launch those polling questions for our audience. We will be taking your questions, as well, today so please do send those in at any time. And if you have joined us in the webinar you can do that using the ask question button.

All right I'm going to cover the legal language on Slide 2 before turning our call over to Cam. This program is being offered through the Federal Financial Institution Examination Council, also known as the FFIEC. Use of these materials by participants,

including video and audio recording of this presentation is strictly prohibited except by written permission of the FFIEC or its members. The views expressed in this presentation are individual views intended for informational purposes and not formal opinions of nor binding on the FFIEC or its members. With all of that out of the way I'm happy to turn the call over to Cam Fuller in Washington D.C.

>> CAM FULLER: Thanks, Jean, good afternoon, everyone and welcome to the FFIEC Working Group Webinar for the LIBOR Transition. My name is Cam Fuller and I'm from the Federal Reserve Bank of New York. And I'm joined by representatives from the other FFIEC member agencies to respond to questions at the end of our presentation.

The FFIEC representatives are Laura Macedo from the Board of Governors of the Federal Reserve System, Lanique Eubanks from the Bureau of Consumer Financial Protection, Lynn Dallin and Judy Gross from the Federal Deposit Insurance Corporation. Ang Middleton from the Office of the Comptroller of the Currency. Thomas Fay from the National Credit Union Administration. Dan Berkland representing the State Liaison Committee and we're also joined by David Bowman of the Board of Governors of the Federal Reserve System.

So, let's get started on Slide 3.

The goals of today's session are to: describe what's happening with LIBOR and why it's important articulate the risks associated with the possible permanent discontinuation of LIBOR; inform financial institutions that FFIEC member agencies have not issued rules or regulations related to LIBOR; and provide financial institutions with information to consider when developing plans for addressing the risks arising from a potential discontinuation of LIBOR.

With that, we can move into the presentation onto Slide 4.

I imagine most of you are familiar with LIBOR and how the various indices are set each day, but I want to go over some basics in order to level set.

LIBOR was short for the London Interbank Offered Rate. It represented the rate at which banks could obtain unsecured funding in the London interbank market. It now represents the rate for all wholesale funding, unsecured funding. It's calculated using an average of rates submitted by panel banks. There are currently between 11 and 16 contributing banks depending on the currency. And panel banks are responding to the following question: At what rate would you borrow funds, were you to do so, by asking

for and accepting interbank offers in a reasonable market just prior to 11 a.m.?

So LIBOR is fixed daily at 11 a.m. London time for five currencies, the U.S. dollar, the pound sterling, the Japanese yen, the Swiss franc, and the euro. And seven maturities are quoted for each currency. Those maturities range from overnight to 12 months, so that 35 rates in all are produced each day.

The three-month tenor is the most frequently referenced rate for each of the currencies. So for example, as of November 19th, there were about 16 panel banks for the US dollar LIBOR. These banks included JP Morgan, Citigroup, Bank of America and Barclays, among others.

As you're aware, LIBOR has been a long-standing benchmark in the global financial system. And it serves as a benchmark rate for numerous financial contracts ranging from interest rate derivatives to mortgages and also floating rate debt and other cash products. Overall, the estimated exposure to U.S. dollar LIBOR is approximately 200 trillion, and this is a number we'll review in more detail on the next slide.

So let's move on to Slide 5.

This table is sourced directly from the second report published by a committee called the Alternative Reference Rates Committee, or the ARRC. I'm going to discuss the ARRC a little bit later in this session. But as you can see, this table shows data as of year-end 2016. And it breaks down the estimated 200 trillion in U.S. dollar LIBOR exposure by instrument class, with an estimate of what percentage of the contracts will mature by the end of 2021, which is the date after which LIBOR may no longer be available.

The largest exposure is in derivatives, which is approximately $190 trillion. And specifically the largest piece of that is interest rate swaps.

There's also trillions of dollars of exposure in cash products. There are 1.8 trillion in floating rate debt, about 1.8 trillion in securitized products, such as mortgage-backed securities and asset-backed securities, 3.4 trillion in business loans, such as syndicated and commercial loans. And 1.3 trillion in retail mortgages and other consumer loans.

Another thing to note on this table, about 20% of these exposures are going to mature after 2021. That's an important date and I'll discuss that later in the session. But keep in mind that these exposure numbers are continuing to grow. Financial institutions are still using LIBOR in financial contracts today

So what this table tells us is a lot of different products reference LIBOR. So that means that financial institutions of all sizes may have LIBOR exposure in their balance sheets.

So with that, this seems like a good time to pause for our first polling question. So I'll turn it back over to Jean.

>> JEAN ROARK: All right, thank you so much, Cam. And please, grab your mouse so that you can respond to our first polling question. I have posed that question so it should pop up on your screen. And I will read the question aloud, along with the responses. So the question says, in order to better meet your future needs, please tell us which one best characterizes your institution's current situation concerning the transition from LIBOR? And you have five options there. The first option is, this webinar is our first education on the topic. Option B is, we are still educating ourselves on the risks and options. Option C is we have a plan to identify how we are impacted. D, we are taking action or monitoring. Or E, our institution will not be impacted if LIBOR goes away.

All right. I think we have them all so I'm going to go ahead and stop that poll. And show the results to all of our participants and also to the room. So I'm looking at my participant view. It has popped up on my screen. So Cam I just wanted to share with you that 45% of our audience are saying we are still educating ourselves on the risks and options. And then the second highest percentage was 22%, Option A, this webinar is our first education on the topic. But then a very close third was Option D, we are taking action or monitoring. So that is all for that polling question. I'm going to stop showing those results, and Cam, I'm going to turn it back over to you.

>> CAM FULLER: Great. Thank you. So let's move on to Slide 6.

During and after the financial crisis, LIBOR came under scrutiny following revelations of manipulation. You may be familiar with the headlines reporting that banks were required to pay large fines for manipulating rates leading up to and during the 2008 financial crisis. There are several factors that contributed to LIBOR being easy to manipulate. One is that LIBOR didn't necessarily reflect actual trades. In other words, panel banks were not required to base their LIBOR submissions on observable transactions and they could submit quotes based on expert judgment.

After some governance reforms, panel banks must now base their quotes on actual transactions if they have any. However, many tenors do not have actual transactions

so many submissions continue to be based on expert judgment.

So this secular decline in the wholesale unsecured funding markets and other weaknesses in LIBOR, coupled with the large volume of transactions that reference LIBOR, which I discussed on the previous slide, has given rise to systemic risk concerns.

In addition, banks have become increasingly reluctant to submit quotes to LIBOR panels. In July of last year, Andrew Bailey, who is the head of the UK FCA, or the Financial Conduct Authority, this is the organization that regulates LIBOR, he gave a speech communicating that the FCA would no longer compel banks that participate on LIBOR panels to provide submissions beyond 2021.

So while some panel banks are reluctant to continue submitting quotes, the FCA reported that it has obtained voluntary agreement from banks to keep submitting quotes through the end of 2021. However, after that date it is unknown how long LIBOR will continue to be published. Given that submissions by banks will be voluntary at that point (so after 2021) there is a material risk that LIBOR will stop after 2021.

So let's look at Slide 7.

This slide shows global efforts over the past several years to address weaknesses of LIBOR and to identify an alternative rate. As you can see in the slide, domestic, and international, and multilateral organizations have all played a role in reference rate reform. This issue really is global and systemic in nature. And it affects markets and institutions worldwide.

So as you can see here, a working group was created essentially for each LIBOR currency to identify an alternative reference rate. I'd like to draw your attention to the IOSCO principles. IOSCO stands for the International Organization of Securities Commission. And they issued principles for financial benchmarks. The most notable of these principles is principle 7, and this states that benchmarks should be anchored in observable transactions.

As a result, several countries have identified new rates. For example, the UK has identified SONIA, which is short for Sterling Overnight Index Average and it's an overnight, unsecured rate in the sterling market. Switzerland has identified SARON, which is short for the Swiss Average Rate Overnight. And it's a secured, overnight rate for the Swiss Franc. The EU has chosen the Euro Short-Term Rate or ESTER. And that's an unsecured, overnight rate.

And finally, we'll focus our talk today on the U.S.'s Alternative Reference Rates Committee. This committee was established in 2014 by the Federal Reserve for the purpose of identifying an alternative rate to U.S. dollar LIBOR.

So let's move on to Slide 8, and I will talk more about the work of the ARRC over the past several years.

So Slide 8. You can see some of the goals of the ARRC we have listed on this slide. It was convened by the Federal Reserve upon the recommendation of the Financial Stability Oversight Council. And even though it was recommended by FSOC and convened by the Fed, it was largely driven by market participants, including about a dozen or so of the largest derivatives dealers. So we have included a slide in the appendix that lists the current members of the ARRC, on which your financial institution might be represented either directly or through various industry trade groups.

The purpose of the ARRC was not only to identify an alternative reference rate to the U.S. dollar LIBOR but also to think about and develop a voluntary transition plan for all financial market participants, not just derivatives dealers.

Another goal of the ARRC is to identify best practices for what we refer to as contract robustness. Most contracts actually do not contain any type of fallback language or appropriate fallback language in the event that LIBOR is no longer published. So as I said, this is something we refer to as contract robustness and it's a goal of the ARRC and it's something I'm going to talk about a little bit later on.

So over the past three years, the ARRC has been working on these objectives. In 2017, it selected the Secured Overnight Financing Rate, or SOFR, as a preferred alternative reference rate to U.S. dollar LIBOR. The ARRC is now working to build liquidity in SOFR, which you might have been seen now being used in floating rate notes, futures contracts, and other products.

So let's move on to Slide 9.

So let's talk a little bit more about SOFR.

It's important to note here that although the ARRC has recommended SOFR as the alternative to LIBOR and has been promoting the voluntary adoption of SOFR, financial institutions are free to choose other alternatives.

SOFR is a short-term U.S. dollar interest rate. It's based on overnight treasury repurchase agreement transactions. The Federal Reserve Bank of New York began publishing this rate on April 3rd of this year.

SOFR provides a broad measure of the cost of financing treasuries overnight, and it's based on trade level data from multiple segments of the treasury repo market. The various segments are tri-party repo markets, the general collateral financing repo, also known as GCF repo, as well as bilateral repos cleared by the Fixed Income Clearing Corporation, also known as FICC.

A key feature of SOFR is that it's entirely transaction based, and it's built on an underlying market that currently trades about $700 billion in daily volume. I think the volume for today's SOFR was about 890 billion. So this is a key difference between SOFR and LIBOR. As I mentioned before, many LIBOR submissions are determined by a survey based on expert judgment rather than actual transactions.

So SOFR is an overnight risk-free rate and it's based on borrowing cash using U.S. treasuries as collateral. This is another important distinction from LIBOR. LIBOR is an unsecured rate.

So let's move on to Slide 10.

So one of the biggest concerns with LIBOR's possible cessation is that it would cause considerable disruption because current language and many financial contracts cannot appropriately handle discontinuance of LIBOR. So, I'll first tackle this issue as it relates to derivatives contracts, but then I'll also talk about cash products.

So first, derivatives are used in a wide range of financial institutions, primarily to hedge interest rate risk. And they, as we talked about earlier, represent the largest exposure for U.S. dollar LIBOR at about 190 trillion. But the good news is that derivatives contracts are mostly standardized.

Most derivatives contracts state that if LIBOR is not available, then the parties must request quotes from two or more reference banks in London or New York. As you can imagine, this was originally contemplated just for a short period of unavailability of the published LIBOR rates. So this concept where essentially you are recreating your own LIBOR, which is what the language in the contract suggests, is not something that can be done on a practical level on a daily basis for a long period of time. So this gives you an indication of the historical confidence that markets had in LIBOR.

The International Swaps and Derivatives Association, also known as ISDA for short, has established working groups to define and implement an alternative methodology in case LIBOR ceases to exist. Once the agreed upon language is determined, it can be embedded into the ISDA contract. So even though it's the largest piece of the U.S. dollar LIBOR exposure, transitioning away from LIBOR could be relatively standardized and easily implemented. So that's in contrast with the cash products where there is more variation in the contracts.

So let's actually move on to Slide 11 and I'll talk a little bit more about the typical contract language in cash products.

So on this slide, we have included a table with a quick summary of what typical fallback language for each product may look like. But it is important to note that there's more variation among the cash products and also within the different products. This table summarizes some typical language for each of these products, but please do keep in mind that this might not be typical for the contracts for your particular financial institution.

So for floating rate notes, the typical contract language will direct the parties to solicit quotes from London banks. So this is just very similar to the ISDA language, which I talked about on the previous slide. The parties would then convert to a fixed rate if quotes are not or cannot be received. And that conversion is typically to the last date that LIBOR was published. That becomes the fixed rate going forward.

So for securitizations, agency and mortgage backed securities will allow Fannie and Freddie to name a successor rate if LIBOR is discontinued. Other securitizations will require a poll of banks. Again, this is similar to the ISDA language and then it converts to a fixed rate if quotes cannot be obtained.

For business loans, the typical contract language appears to name the prime or the effective fed funds rate plus a spread as the fallback. Again, I think it typically reverts to when LIBOR was last published and then it will become a new fixed rate.

For mortgages and other consumer products, typically the noteholder has the authority to name the successor rate if LIBOR is discontinued. But I do want to quickly point out two facts concerning the contract language for most mortgages. First, the contract language is silent on how or if the margin or the spread to the reference rate could be adjusted. Second, the language is silent on how to switch to a new successor rate if LIBOR is not permanently discontinued and then becomes unreliable or not regularly quoted.

So again, I think the biggest takeaway from this Slide 11 is just to show that for cash products, there is going to be more complexity and there's less clarity going forward because each of these product types, there's just less standardization than you see in the derivatives products.

Okay. So with that, we can move on to Slide 12.

So while the end of 2021 does seem like a very long time from now, the potential change is material. And it's material enough that financial institutions with exposure to LIBOR might need this entire runway period to address all of the risks that are going to come up between now and the end of 2021. So plans to address this potential risk will vary from financial institution to financial institution just because of the level of exposure is going to be different between the institutions.

So we are raising awareness now and encouraging everyone to start thinking about this risk and determine their level of exposure and identify ways to mitigate the risks for them.

Financial institutions that understand the risks, that understand the types of products that are impacted, and what solutions are being proposed by the ARRC, as well as other groups that are proposing alternative benchmark rates, those should be better prepared for the transition.

The ARRC is meant to serve as a forum to coordinate across all products as market participants begin to transition to alternative reference rates and address these challenges as they arise. I'll just walk through some of the potential challenges very quickly, but I do encourage you to visit the websites that we have shared in the appendix for additional information. The FAQ in particular is especially informative.

The ARRC and its various working groups have identified and recommended SOFR as the alternative reference rate. They have published replacement contract language for some products and are working to address other future challenges. As the transition moves forward, other hurdles are going to pop up and input from market participants is important to steer the work of the ARRC and highlight what needs to be addressed.

So the ARRC is currently working on fallback contract language for various types of financial products and published for comment contract language for floating rate notes and syndicated business loans. And the comment periods for those two products just

recently closed. Another challenge is the need for a credit spread to address moving from LIBOR, which is an unsecured rate, to SOFR which is a secured rate. Another one that I'm sure many of you are interested in is the need for a term structure, since SOFR is an overnight rate and LIBOR is currently quoted for various tenors.

So the Federal Reserve has discussed the possibility that it will produce a daily backward-looking average of SOFR that could be used for this purpose. The ARRC also has a working group dedicated to the development of a forward-looking term rate. And lastly but importantly, is building up liquidity in the derivatives markets that are linked to SOFR. This will help with the development of a term structure rate.

So now seems like another good time to pause for another polling question so I'll turn it back over to Jean.

>> JEAN ROARK: Okay thank you so much, Cam. I really appreciate you turning it back over to me. I have launched our second polling question. So that box should pop up on your screen. And I'll read the question aloud and I'll also give you the options. So the question is for future educational purposes, please tell us what percentage of your institution's assets, liabilities, and off-balance sheet transactions are indexed to LIBOR? So you have a couple of options there. Your first option is 10% or lower. Or is it between 10% and 25%? Between 25% and 50%? Is it higher than 50%? Is it unknown at this time? Or does it not apply to you?

I'm going to go ahead and stop that poll and show the results to Cam and all of the folks in the room in D.C. and then also to all of our participants. So Cam, just so you know, it looks like 25% of our participants have selected the first option, Option A, and their answer was 10% or lower. And the next highest percentage is 21% and that was letter E, unknown at this time. So I will turn the call back over to you.

>> CAM FULLER: Okay. Great. Thank you for doing that second poll for everyone. Okay. So we can actually turn now to Slide 13.

This slide we have just listed some questions. And these questions can help you as you're beginning to consider the impact of the LIBOR transition on your institution. So I will let participants read through those as they see fit.

And then finally, I'm going to turn to Slide 14.

And we would like to emphasize that none of the FFIEC member agencies have issued rules or regulations at this time regarding the transition from LIBOR. This is

something I mentioned at the very beginning.

And at this time, our focus is on raising awareness and educating financial institutions and examiners about what is happening with LIBOR so that all affected financial institutions can begin to prepare and not be caught off guard by a potential market change.

So examiners are encouraged to assist in this education process by discussing the topic with their supervised institutions and understanding how financial institutions are starting to plan for a potential transition away from LIBOR.

So I thank you for your patience and we'll open it up for questions, unless we have a couple more polling questions. Actually we have two more polling questions.

>> JEAN ROARK: I am going to launch that next polling question so that is posed for the group. And I'll read it aloud along with the options for response. All right. The question is, in order to tailor future education sessions, please select the product or products your institution is most concerned with regarding the transition from LIBOR? Is it over-the-counter derivatives, exchange traded derivatives, business loans, consumer loans, bonds, securitizations, or none?

So I'm going to go ahead and hit stop for now. And I will show those results to our participants and also to Cam and her friends in the room. Okay. So Cam, it looks like 46% of our participants have selected business loans. And 22% selected consumer loans. And then the next closest was 10% of our participants selected over-the-counter derivatives.

So this one we're going to do just a little bit differently because we want to solicit your responses. So it's more of an open-ended question. So you should see a link pop up on your screen. Either your screen opened to a different web page which is a survey, or you have a box that says URL on the top and you can just click here to open that URL. But the question is, if we were to conduct future education sessions about the LIBOR transition, what topics would you be interested in? So I hope that you did receive that link and you're able to respond. Unfortunately, I don't have a way to show those results to our audience. So when you're finished with that response, you can just go ahead and close out that window. But don't close out our webinar window. Leave that one open. So all right. With that, that was the last polling question.

>> JEAN ROARK: So unfortunately, I don't think we have any more time for questions. But I do want to thank Cam Fuller and all of the folks who joined at the Board of Governors in Washington D.C. to answer questions today. You will receive an email shortly with a link to a survey. Please do take a couple of minutes to fill that out. We really care about your feedback and we do read every line of your feedback and take it into consideration. Well, this does conclude our FFIEC Industry Outreach call for the today. I hope you have a great rest of your day.