INVESTMENT COMPANY INSTITUTE

MEMO# 32930

November 20, 2020

LIBOR Update: Updates from the Financial Stability Board

[32930]

November 20, 2020 TO: ICI Global Regulated Funds Committee
LIBOR Transition Working Group
SEC Rules Committee RE: LIBOR Update: Updates from the Financial Stability Board

On November 20, 2020, the Financial Stability Board (FSB) issued a progress report on benchmark reform.[1] The report's key message is that regulatory action may not be enough to address all LIBOR transition issues and that market participants should continue to focus on active transition. Specifically:

- For transition to occur on time, market participants will need to cease use of LIBOR as a benchmark in all new activity across global markets as soon as possible and this needs to be a key priority for the months ahead.
- For tough legacy contracts, market participants should continue to progress their transition efforts proactively, particularly through active conversion of rates in contracts and the insertion of robust and workable fallbacks where feasible.
- Even if regulatory or legislative action on tough legacy contracts is feasible, parties who rely on such action will not have control over the economic terms of that action.
- Market participants should continue to focus on active transition to have certainty about contractual continuity and control over their contractual terms when LIBOR ceases or is no longer representative.

The report comprehensively addresses benchmark transition progress in major currencies and G20 markets as well as the derivatives market and accounting, tax, and regulatory work. Below, we provide more detail on the report's takeaways on the effect of the COVID-19 crisis on transition efforts and the progress in the transition of USD LIBOR.

COVID-19 Crisis Impact on Transition

The report finds that the disruption to global financial markets associated with the COVID-19 pandemic "highlighted the fundamental weaknesses in LIBOR." In particular, the direct correlation between LIBOR and banks' overall borrowing costs during that time weakened, given a much lower dependence on the short-term unsecured markets that LIBOR seeks to measure.

At the same time, there was an increase in the most widely used LIBOR rates in March 2020, which put upward pressure on the financing cost of those paying LIBOR-based rates. While central bank rates were being reduced globally to near zero, LIBOR rates actually increased. The report concludes that those increases were passed on to end users of the financial system.

The report further relays concerns that amid COVID-19 related market stress and the remote-working environment, some market participants experienced delays in transition efforts. The report also finds, however, that regulators during that time reaffirmed the targeted LIBOR cessation timeframe of end 2021, leading to a reduction in uncertainty about LIBOR transition timelines.

Progress on USD LIBOR Transition

The report lauds the efforts of the ARRC and other policymakers in providing guidance and resources to market participants on USD LIBOR transition. Looking ahead, the FSB identifies the following areas of focus for transitioning USD LIBOR:

- Movement of legacy derivative positions from LIBOR to SOFR before end-2021;
- Development of tools to support operational and infrastructure preparedness;
- Work on potential legislative relief for legacy contracts that may be otherwise difficult to amend and that do not have economically appropriate fallbacks;
- Continued work on tax, regulatory and accounting measures to support the transition; and
- Broad outreach and education around transition work.

Regarding SOFR liquidity, the report finds that it has continued to increase, although it remains less liquid than U.S. dollar LIBOR. Both LIBOR and SOFR derivatives activity has declined since policy rates were cut to near zero in March, but the value of SOFR futures outstanding has grown to 10 percent of LIBOR futures. The report also finds that activity in longer-dated SOFR swaps has grown in recent months, likely in anticipation of the “Big Bang” move to SOFR discounting at CME and LCH in October 2020. The total amount of SOFR-based debt issued now exceeds $750 billion, roughly double the amount at the start of the year.

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endnotes

[1] *See* Reforming Major Interest Rate Benchmarks: 2020 Progress report (November 20, 2020), *available at* https://www.fsb.org/wp-content/uploads/P191120.pdf.

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