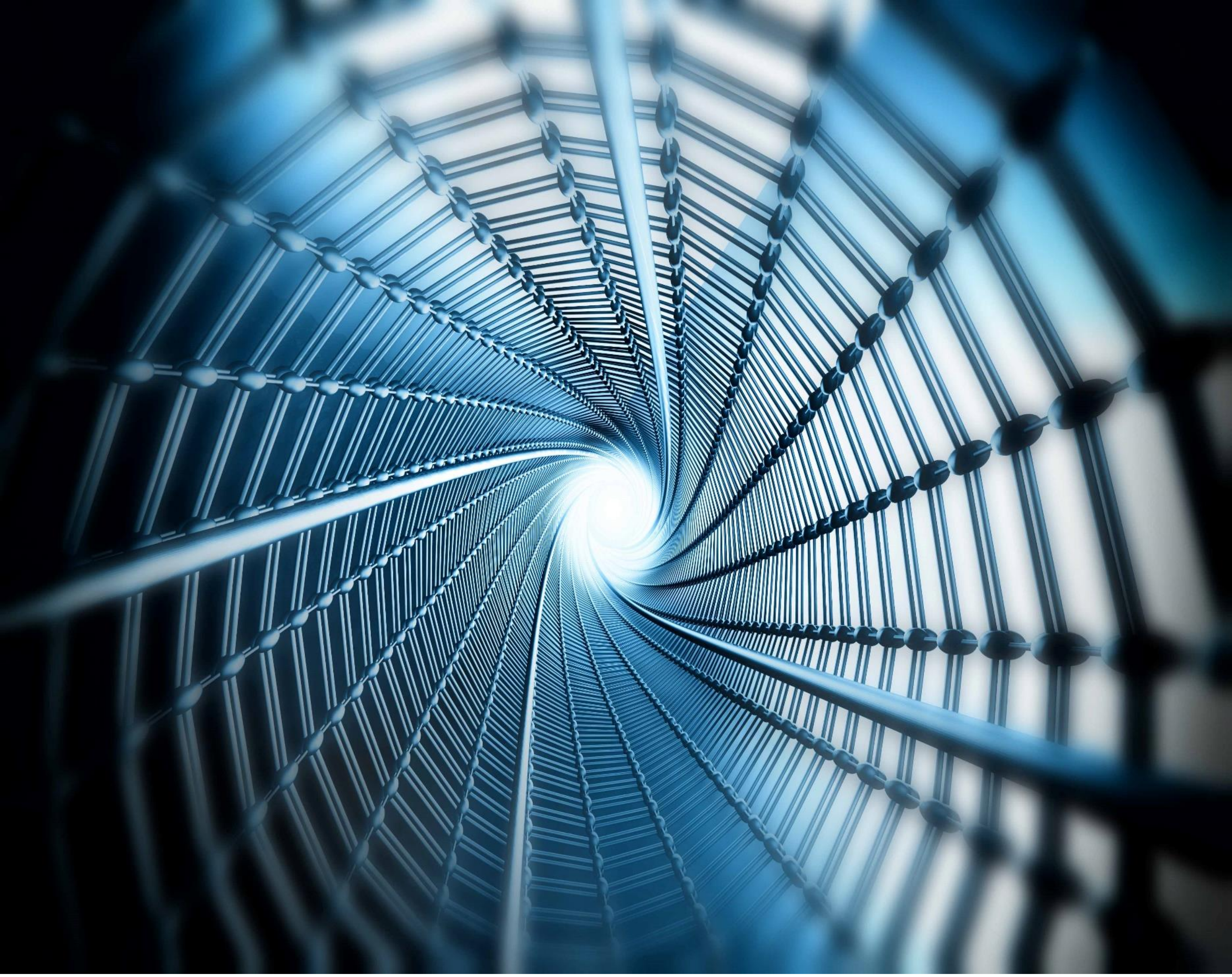

LIBOR Transition – Are We There Yet?

July 2022

J.P.Morgan

Non-USD LIBOR Transition – job done…almost

December 31, 2021 was a major milestone date in the LIBOR transition. It was the cessation date for four of the five LIBOR markets - Sterling, Yen, Swiss, and Euro LIBOR are now discontinued. Preparation for the event was not without significant effort but the cessation date itself came and went without market disruption. The vast majority of any outstanding contracts in those markets are now fixed to the designated fallbacks. Some work, however, remains to be done. In the case of Sterling and Yen, a portion of those contracts that are considered 'tough legacy' are fixed for a one-year period, through the end of 2022 to a synthetic LIBOR, which is calculated and published by ICE Benchmark Administration. Participants in those markets have until the end of this year to restructure and unwind the more complex trades or agree on an appropriate fallback. The European Commission was expected to issue implementing acts to designate replacement rates for certain Sterling LIBOR[1] rates and certain Yen LIBOR[2] rates in the first quarter of 2022, but publication remains pending at this time. On June 30, 2022, the UK Financial Conduct Authority (FCA) launched a consultation (CP22/11)[3] on the transition away from the one-month, three-month and six-month sterling LIBOR settings and market participants' exposure to US Dollar (USD) LIBOR.

USD LIBOR Transition – a work in progress

The cessation date for USD LIBOR is June 30, 2023. The remaining USD settings will continue to be calculated using panel bank submissions until cessation.

Banking regulation in effect

US banking regulatory guidance of no new LIBOR issuance beyond 2021 is now in effect[4]. This means that any LIBOR trading that is done now is for risk reduction purposes only. Certain new USD LIBOR contracts still could be issued in scenarios where a contract meets prescribed exception criteria of the Federal Reserve Bank (FRB), or a contract is written among nonbank parties that are not overseen by US banking regulators.

The UK FCA has banned the new use of all USD LIBOR settings in the UK, but also allowed for certain exceptions[5].

SOFR liquidity

In 2022, almost all of new business across products is now in the Secured Overnight Financing Rate (SOFR) with very little LIBOR trading. There were three SOFR First dates orchestrated in the OTC markets between July and November of 2021 for interest rate swaps, cross currency swaps in developed markets, and then swaps in caps and floors. These were by all accounts successful. At each of these dates, in the interbank markets, the dealers shifted the vast majority of their volumes from LIBOR to SOFR and then customer volumes followed soon after that. In its January 2022 newsletter[6] the Alternative Reference Rates Committee (ARRC) stated, "SOFR now accounts for the majority of risk traded by LCH, and throughout 2022, syndicated loans have continued to move to SOFR. CME has also noted that SOFR trading activity "hastened dramatically to begin 2022, with… activity in SOFR futures and swaps surging relative to their Libor-based counterparts."" Most recently,

[1] British pound LIBOR – designation of statutory replacement rate
[2] Japanese yen LIBOR – designation of statutory replacement rate
[3] *https://www.fca.org.uk/publications/consultation-papers/cp22-11-winding-down-synthetic-libor-us-dollar-libor*
[4] The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation Statement on LIBOR Transition – November 30, 2020
[5] FCA Article 21A Benchmarks Regulation – Notice of prohibition on new use of a critical benchmark
[6] ARRC Newsletter December 2021 – January 22

the Chicago Mercantile Exchange (CME) Group announced[7] that it will be launching 'SOFR First for Options', during the months of June and July to aid in the transition of the exchange-traded options market, which is one of the last major markets which needs to move away from USD LIBOR.

Legislative progress

US federal legislation

On March 15, 2022, US President Biden signed into law the Consolidated Appropriations Act, 2022, which includes federal legislation, the Adjustable Interest Rate (LIBOR) Act (the Act), that provides a solution for legacy financial contracts tied to USD LIBOR. The Act provides clarity, prevents disruption, and creates safe harbors for the transition from USD LIBOR to SOFR for tough legacy contracts at USD LIBOR cessation on June 30, 2023.

Application of the Act does not depend upon what type of contract it is (e.g., a security, loan, mortgage, swap, etc.), but rather depends upon whether and how provisions in the contract deal with the replacement of LIBOR - the fallback provisions.

The legislation requires the FRB to issue regulations specifying SOFR based benchmark replacement rates no later than 180 days after the legislation becomes effective – expected publication in September 2022.

The UK Financial Conduct Authority

The Adjustable Interest Rate Act provides guidance only for USD LIBOR contracts negotiated under US Law. For UK Law contracts, it is possible that the FCA may consider allowing legacy use of a synthetic version of USD LIBOR after June 30, 2023, assuming that a large number of contracts referencing USD LIBOR in the one-month, three-month, and six-month tenors are still outstanding at that time - but this has yet to be determined and the assumption should be made this will not be the case. Any decision on this is unlikely to occur in 2022.

Clearing houses

LCH Ltd (LCH) and CME have announced[8] initial plans to convert all outstanding USD LIBOR cleared swaps to SOFR-referencing Overnight Index Swaps just prior to June 30, 2023.

CME term rate

In light of the successful implementation of the first phase of SOFR First, the ARRC formally announced that a forward-looking term rate based on SOFR and published by the CME Group is an appropriate fallback to USD LIBOR and may be used for certain types of transactions. The CME Group is currently publishing one-month, three-month, and six-month tenors of CME Term SOFR. On May 19, 2022, the ARRC announced[9] its endorsement of the CME Group’s forward-looking twelve-month SOFR term rate for certain uses in line with its Best Practice Recommendations Related to Scope of Use.

[7] CME announces Options SOFR First Day
[8] LCH consultation on converting cleared USD contracts; CME consultation on converting cleared USD contracts
[9] ARRC Provides Update Endorsing CME 12-Month SOFR Term Rate

Loans

As of January 1, 2022, the market is no longer permitted to use LIBOR in new loans per regulatory guidance. New loans are considered to include new facilities, refinancing of existing facilities or draws under uncommitted lines of credit. To date, this has been well adhered to, and the market has broadly adopted CME's forward-looking Term SOFR rate. Existing committed facilities that are outstanding may continue to use USD LIBOR for calculation of interest up to June 2023. Focus is now very much centered on legacy population of facilities that reference USD LIBOR, and the remediation of these by means of (i) refinance (ii) amendment to modify the interest rate provisions from LIBOR to alternative benchmark, or (iii) amendments to agreements where there is no defined LIBOR fallback mechanism to a defined benchmark (i.e., ARRC hardwired fallback[10]).

The next twelve months

While regulatory encouragement and bans have ended most issuance of new LIBOR-indexed contracts, the remediation of existing LIBOR-indexed contracts is still in process. The fourth quarter of 2021 saw intensified remediation activity among the settings that were scheduled to end in 2021. Market participants who had been slow to prepare managed to scale up their transition programs and make the December 31, 2022 deadline. Such last-minute races to the finish line are not likely to work as well with USD LIBOR remediation, because of the significantly greater volume of contracts.

One area of current market participant and industry focus is the transition of USD-linked Floating Rate Notes (FRNs). At the start of 2022, the ARRC's Operations and Infrastructure (O&I) Working Group (WG)[11] set out a program of work to create a centralized and harmonized process to communicate transition changes for FRNs. One of the objectives of the ARRC O&I WG is to have a workable solution in place in time to prevent a deluge of rate/term amendment communications all at once and in the eleventh hour. The key elements of the proposed process include:

- ❖ Data: Determine the minimum data set required to communicate rate changes to investors and infrastructure providers (e.g., Middle Office, Fund Accounting, Back Office, etc.)
- ❖ Communication Protocol: Design a solution framework in a structured data format for communication gateways from the Determining Parties to DTCC and ultimately to third party market reference data providers and onward to end-users

Implementation of a workable and effective end-to-end process to communicate key rate and term changes is critical for the success of the transition of USD LIBOR-linked FRNs. Note, the ARRC has recommended that the determining party communicate contract changes to the counterparty at least six months in advance of any LIBOR maturity[12]. With this recommendation in mind, the ARRC O&I WG aims to implement its proposed operating model no later than by the end of 2022.

[10] ARRC Fallbacks

[11] The ARRC's Operations and Infrastructure Working Group was originally formed to identify key infrastructure and operational changes that need to be enacted in order to allow for a smooth, market-wide transition from US Dollar LIBOR or to allow for the adoption and use of SOFR where desired across derivatives, cash products, and systems.

[12] ARRC Recommended Best Practices for Completing the Transition from LIBOR

J.P. Morgan Securities Services LIBOR Transition Program Update

As of year-end 2021, Securities Services:

- **New Risk-Free Rates (RFRs):** Completed work to establish operational readiness for the new alternative RFR transactions including:
  - Rates and Instruments: Updated systems and processes to incorporate the new RFRs and to support RFR-linked products (Floating Rate Notes, Bank Loans and OTC Derivatives)
  - Accruals: Enhanced accounting platform capabilities to calculate income accruals based on new methodologies (e.g., compounding in arrears; observation shift, etc.)
  - Valuation: Updated independent valuation methodologies to RFR-based discounting as applicable
- **Legacy Non-USD LIBOR Contracts:** Developed transaction processing models and partnered with clients and/or their third-party investment managers to successfully execute the asset class-specific transition of legacy Non-USD LIBOR-linked products to new RFRs.
  - Cleared Swaps – Supported the LCH and CME conversions of trades referencing British pound (GBP), Swiss franc (CHF), and Japanese yen (JPY) LIBOR and Euro Overnight Index Average (EONIA)
  - Non-Cleared Swaps – Designed and developed systemic solution to fallback impacted contracts
  - Loans – Supported the repapering of deals and the rate re-fixes to the new RFRs
- **Client Communication and Engagement:** Kept clients informed of industry and regulatory developments as well as the progress of our LIBOR Transition Program through a series of webinars, briefings, one-to-one meetings and targeted outreach to clients who, for example, held positions in cleared OTC swaps that converted to RFR contracts in the second half of 2021.

In the first half of 2022, Securities Services:

- **Tough Legacy Non-USD Contracts:** Managed the inventory of client holdings in tough legacy Non-USD linked FRNs, loans and non-cleared swaps (held at December 31, 2022). Using this inventory of assets, organized according to their 2022 reset dates, ensured that each tough legacy holding was updated with an appropriate replacement rate.
- **USD LIBOR-Linked FRNs:** Engaged and participated with the ARRC Operations and Infrastructure Working Group to support the initiative to create a communications protocol to effectively enable Determining Parties and Issuers to notify the market of changes in rates/terms for USD LIBOR-linked FRNs.
- **Regulatory Developments:** Closely tracked the legislative progress in various jurisdictions calibrating outcomes and/or potential outcomes and impacts to our LIBOR program and to our clients.
- **Non-Cleared Swaps and Loans:** Tracked rate resets and subsequent cash flows to ensure the proper RFR rate was applied.

LIBOR Transition – Are We There Yet?

Between now and the permanent cessation of USD LIBOR in June 2023, the Securities Services' LIBOR Program will focus on the transition of remaining legacy LIBOR exposure. We anticipate the publication of:

- FRB regulations (off the back of the Adjustable Interest Rate Act) for tough legacy USD LIBOR contracts under US Law;
- Potential FCA action with regards to synthetic USD LIBOR for USD LIBOR contracts under UK Law;
- The FCA consultation on synthetic Sterling LIBOR; and
- Further announcements and consultation of LCH and CME planned conversion of USD LIBOR-linked cleared OTC swap positions

While the cessation of USD LIBOR is still nearly a year away, clients may wish to take inventory of their USD LIBOR holdings and:

- Assess opportunities to transition portfolios from LIBOR to SOFR. With respect to regulatory and market developments, there is little to no uncertainty left - the dates have been set, the fallbacks are in place, the products are available and liquid. Market participants will likely reach a point where they simply do not wish to manage an existing legacy portfolio of LIBOR derivatives, for example, alongside a growing portfolio of SOFR derivatives. They may also wish to avoid waiting and reaching the point where LIBOR liquidity becomes a real consideration.
- Begin the process to update project/action plans to manage transition-related activities for LIBOR holdings that cannot be easily transitioned (e.g., tough legacy) or which will be converted by clearing houses in the months just prior to cessation date.

Securities Services will continue to communicate with our clients sharing progress, notifying them of any anticipated challenges and informing them when we will again need to partner together to ensure a successful transition.

Contributors

LIBOR Transition – Are We There Yet?

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