LATHAM & WATKINS

Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

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Regulators Gear Up for LIBOR Transition Testing

In anticipation of LIBOR discontinuation, key US and UK regulators signal a shift toward examining transition progress.

After an initial phase of applying mostly verbal pressure, UK and US regulators are now taking a more hands-on approach to supervising financial institutions' London Inter-bank Offered Rate (LIBOR) transition planning and execution. LIBOR will no longer be functional after 2021, as most market participants are aware.

For example, nearly a year after the US Securities and Exchange Commission's (SEC's) release of a Staff Statement on LIBOR Transition, the SEC's Office of Compliance Inspections and Examinations (OCIE) released a LIBOR-focused Risk Alert on June 18, 2020 (Examination Initiative: LIBOR Transition Preparedness), demonstrating a shift of focus from passively monitoring LIBOR-transition risks to actively testing SEC-registered firms on their progress. OCIE had previously mentioned LIBOR transition as an area to watch in its 2020 Examination Priorities, noting that "OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors." The Alert, however, is more elaborate and specific regarding what OCIE will be reviewing and the type of documentary evidence it will be seeking in its examinations.

Likewise, on July 1, 2020, the members of the Federal Financial Institutions Examination Council (FFIEC)[1] — tasked with prescribing and promoting uniform principles and standards in the supervision of US financial institutions — issued a Joint Statement urging supervised institutions to prepare for LIBOR transition and to address associated risks. The Office of the Comptroller of the Currency (OCC) released a statement of its own, expanding on the FFIEC statement, with detailed suggestions for regulated banks (Bulletin 2020-68).

In the UK, regulators have required quarterly data from regulated firms on their LIBOR transition progress since September 2019, and regularly issue public statements on their key areas of focus.

This *Client Alert* reviews the recent statements that regulators have made regarding LIBOR transition and notes the implications for market participants.

SEC

OCIE's Alert provides SEC registrants with specific information about the scope and content of OCIE's upcoming LIBOR-transition examinations and information requests. Registrants, including investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents, and clearing agencies, may find the Alert helpful in reviewing and formulating their own plans and priorities.

OCIE intends to review the extent to which registrants have evaluated the potential internal and external impacts of transitioning away from LIBOR, specifically as such impacts relate to a firm's:

- Business activities
- Operations
- Services
- Customers, clients, or investors

Specifically, OCIE will review registrants' plans and progress with regard to:

- **Inventory:** Assessment of exposure to LIBOR-linked contracts with maturities beyond the expected discontinuation date of December 31, 2021
- **Fallbacks:** Implementation of fallback language into impacted contracts
- **Operational readiness:** Enhancements or modifications to systems, controls, processes, and risk or valuation models
- **Communications:** Disclosures, representations, and reporting to investors regarding LIBOR transition efforts
- **Conflicts:** Identification and remediation of any potential conflicts of interest arising from LIBOR transition
- **Clients' efforts:** Assessment of clients' efforts to employ appropriate alternative reference rates

Appended to the Alert is an extensive (although not exclusive) list of potential documents and categories of information that OCIE may request from registrants during LIBOR transition examinations. While examinations may vary depending on the facts and circumstances of each registrant, requests for information may relate to:

- Organizational structure, particularly as it may be impacted by LIBOR transition
- Individuals or committees responsible for LIBOR transition oversight, and their related activities
- Impact assessments and results
- Strategic plans and timelines
- Risk management documentation

- Impacted risk and valuation models
- Communication made both externally to clients and internally to management, employees, or supervised persons
- Third parties or vendors that may be impacted by the LIBOR transition, or that a registrant may have employed to assist with the transition

FFIEC

LIBOR transition implicates all regulated financial institutions, and the FFIEC statement highlights the financial, legal, operational, and consumer protection risks that must be managed in advance of the expected cessation date. The FFIEC Joint Statement raises many of the same concerns that are described in the OCIE Alert, including inventory of exposures, fallback implementation, operational readiness, and communications with clients and counterparties. It also highlights additional concerns of particular importance to retail financial institutions, including risks associated with reliance on third-party service providers, consumer protection implications, reputational risk, and the potential litigation risk arising from LIBOR transition.

The Joint Statement asserts that the “supervisory focus on evaluating institutions’ preparedness for LIBOR’s discontinuation will increase during 2020 and 2021.” Financial institutions and executives tasked with responsibility for LIBOR transition programs can expect that their planning and risk mitigation efforts will be subject to examiner scrutiny in the months ahead.

OCC

The OCC Bulletin provides banks with further guidance for identifying and managing LIBOR transition risks. The OCC includes detailed recommendations for banks on the following topics:

- **Risk management:** Exposure assessment, transition planning, operational impact, infrastructure capability, and assignment of managerial responsibility
- **Fallback language:** Assessment of fallback language, triggers, replacement rates, and adjusted spreads, as well as communications with relevant counterparties
- **Replacement rate:** Selection of appropriate replacement rates and adjustment methodologies
- **Risk to earnings related to Libor transition:** Assessment and control of value transfer risks

While no mention is made of the regulator’s examination agenda, regulated institutions of all sizes can assume that supervisory priority will be given to the topics noted, as well as those noted by the FFIEC and OCIE.

FCA and PRA

On May 13, 2020, the UK Prudential Regulation Authority (PRA) and UK Financial Conduct Authority (FCA) announced a resumption of full supervisory engagement with firms on their LIBOR transition progress beginning June 1, 2020, including the resumption of LIBOR transition data reporting at the end of Q2 (previously suspended at the end of Q1 due to the COVID-19 pandemic). The UK regulators have been engaging with firms on their LIBOR transition efforts for several years. In particular, in September 2018, the FCA and PRA wrote to CEOs of major banks and insurers that are supervised in the UK asking for details of the preparations and actions they were taking to manage LIBOR transition. The letters sought assurance that firms' senior managers and governance committees understood the risks associated with LIBOR transition and were taking appropriate action. This "Dear CEO" letter was followed in June 2019 by a joint letter from the FCA and PRA summarizing the responses received to the September 2018 Dear CEO letter, noting examples of good practice. This was followed by a "Dear SMF" (senior management function) letter in January 2020 that set out the FCA and PRA's initial expectations for transition progress during 2020, followed by a letter to asset management firms calling on them to prepare for the end of LIBOR and outlining a number of regulatory expectations.

There is no specific mention of the FCA or PRA's examination agenda. The numerous public statements made by both the regulators and the Working Group on Sterling Risk-Free Reference Rates (RFRWG) (including those mentioned above), however, indicate that the supervisory focus will cover areas similar to those that the US regulators are concerned with, in particular:

- Robust and comprehensive transition plans
- Conduct risk
- Prudential risks
- Senior management and board engagement
- Risk assessment and risk management
- Fair treatment of customers
- Ceasing new LIBOR usage, in accordance with RFRWG targets

ARRC

The Alternative Reference Rates Committee (ARRC),[2] standard setter for the US LIBOR transition, issued Recommended Best Practices for Completing the Transition from LIBOR on May 27, 2020. The Best Practices and related Practical Implementation Checklist for SOFR Adoption and Timeline are "intended to serve as guidelines for market participants seeking to organize their operations in a manner that fosters strong controls, reinforces overall market integrity, and promotes a successful transition away from LIBOR." The milestones and internal planning recommendations apply to a broad range of market participants and products, such as floating rate notes, business loans, consumer loans, securitizations, and derivatives.

The ARRC recommends the following best practices:

- Institutions should take active steps to meet the timelines set out in the recommended transition milestones, specifically for incorporation of hardwired fallbacks, readiness of tech/ops vendors, cessation of new LIBOR usage, and implementation of new risk-free rates.
- Institutions should implement clear internal programs and governance frameworks to prepare for a transition away from USD LIBOR, including a rigorous assessment of exposures and accountable senior executives

- Institutions should develop a communication strategy and maintain ongoing dialogue with their key internal and external stakeholders to promote awareness of transition activity

Although the recommendations are not binding rules or official regulatory guidance, regulators, in their supervisory capacity, will likely look to the ARRC's transition timeline and suggested best practices to gauge the progress of market participants in future examinations.

Implications

Market participants have long been aware of the complex set of operational challenges that the discontinuation of LIBOR will pose. The intervening COVID-19 pandemic undoubtedly diverted resources and attention away from execution of LIBOR transition plans. Market participants should, however, keep LIBOR transition in focus and continue to address the array of challenges it presents, as regulatory authorities on both sides of the Atlantic have communicated that LIBOR discontinuation remains on track, and transition testing will gain momentum.

In its 2020 Examination Priorities, OCIE warned that "insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants." Regulatory risk can be added to that list as regulators begin to incorporate LIBOR-transition readiness into forthcoming reviews and examinations.

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[CFTC Issues No-Action Relief for Derivatives Market IBOR Transition]

Endnotes

[1] The Council consists of the following six voting members: a member of the Board of Governors of the Federal Reserve System; the Chairman of the Federal Deposit Insurance Corporation; the Director of the Consumer Financial Protection Bureau; the Comptroller of the Currency; the Chairman of the National Credit Union Administration; and the Chairman of the State Liaison Committee.

[2] The ARRC is self-described as "a group of private-market participants convened to help ensure a successful transition from USD LIBOR to a more robust reference rate, its recommended alternative, the Secured Overnight Financing Rate (SOFR). It is comprised of a diverse set of private-sector entities, each with an important presence in markets affected by USD LIBOR, and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members."