Client Alert | Financial Institutions Advisory

NYDFS Requires LIBOR Transition Plans by Early February

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On December 23, 2019, the New York Department of Financial Services (NYDFS) issued an Industry Letter instructing each institution it regulates, including banks and licensed Fintechs, to make submissions describing the institution's transition plans and any associated risk in connection with the cessation of the London Interbank Offered Rate (LIBOR). Responses are due to the NYDFS by February 7, 2020.

LIBOR Transition and the NYDFS Request

The NYDFS Industry Letter[1] notes that the UK Financial Conduct Authority (FCA) will no longer compel banks to furnish data to support the determination of LIBOR after the end of 2021, meaning LIBOR is unlikely to continue thereafter. In the United States, the Alternative Reference Rates Committee (ARRC), spearheaded by the Federal Reserve Board (FRB) and Federal Reserve Bank of New York (FRBNY), recommends the Secured Overnight Financing Rate (SOFR) as an alternative to US dollar LIBOR. FRBNY describes SOFR as "a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities," as a LIBOR replacement. In particular, the ARRC believes the SOFR is preferable over LIBOR because, among other reasons, it: (1) has a reliable administrator; (2) is an overnight and low risk reference rate and (3) is fully transaction-based with a robust underlying repo market. The FCA and the Bank of England similarly have proposed the Sterling Overnight Index Average (SONIA) as a replacement benchmark that would be based on deposit/money market rates.

In the Industry Letter, the NYDFS stated that it believes the substantial volume of existing loans, derivatives, securitizations and other transactions or instruments linked to LIBOR requires prudent risk management by all NYDFS-supervised financial institutions with LIBOR exposure, including banks and other depository institutions, New York branches of non-US banks, insurance companies and supervised nonbank Fintechs such as licensed lenders, money transmitters and virtual currency companies. The NYDFS expects each supervised institution to "fully understand its cessation and transition risks, and the implications for them and their customers and counterparties." The NYDFS specifically cites commercial loans that are expected to be renegotiated or amended before 2021 and OTC derivative transactions that will extend beyond 2021 as potentially requiring renegotiation and amendment to allow for conversion to an alternative rate, or at least to include fallback provisions to identify the triggers for introducing a replacement to LIBOR prior to its discontinuation. The Industry Letter further states that the NYDFS recognizes that LIBOR-based residential mortgage loans and other consumer loans may include provisions that allow the lender to choose an alternative rate, while noting that changing the interest rate basis on a consumer loan presents legal, reputational and operational risks that must be carefully considered and managed.

[1] NYDFS, Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, December 23, 2019.

In light of the potential risks presented by LIBOR's cessation, the NYDFS is requiring each bank and nonbank it supervises to submit, by February 7, 2020, a description of the institution's plan to address LIBOR cessation and transition risk, including:

1. programs that would identify, measure, monitor and manage all financial and non-financial risks of any transition;
2. processes for analyzing and assessing alternative rates, and the potential associated benefits and risks of such rates both for the institution and its customers and counterparties;
3. processes for communications with customers and counterparties;
4. a process and plan for operational readiness, including related accounting, tax and reporting aspects of any transition; and
5. the governance framework, including oversight by the board of directors, or the equivalent governing authority, of the institution.

Transition Risks

Institutions should consider the extent to which existing LIBOR-linked portfolios present the following potential risks and consider the adequacy of their transition plans in addressing any such potential risks:

- *Transition Risk*. Varying degrees of negotiation and redrafting may be required to transition away from LIBOR. Some products may already include procedures for an orderly transition, while others may require contested and time-consuming negotiations, in particular, for non-derivative products where an industry consensus protocol does not develop. The process for obtaining required customer and counterparty consents should be proactively mapped out.
- *Gap Risk.* A transition could create potential basis risk arising from the possibility that a hedging transaction and the underlying transaction for which it hedges (e.g., an interest rate swap and a floating-rate loan) may transition at different times, to a different rate or with different adjustments.
- *Rate Risk*. New rates such as SOFR, which itself may not yet have robust derivatives trading and which may not yet have widespread market acceptance, is more susceptible to material fluctuations. At present, it is more expensive to hedge interest rate and other exposures using SOFR-linked derivatives than LIBOR-linked derivatives, because liquidity for SOFR, which has been published only since 2018, remains thin.
- *Litigation Risk*. Disputes resulting from elements of transition risk, gap risk or rate risk could lead to litigations throughout the market. In addition, many legacy agreements include "fallback" clauses saying, sometimes vaguely, that the parties will agree at a later date on the new rates and spreads to be used once a LIBOR phase-out occurs. If parties are unable to agree, litigation regarding what rates are to be paid may result.

To address these risks, institutions should in any case proactively prepare for the LIBOR transition. As is further discussed in our December 2019 article "Uncertainty surrounds the shift from LIBOR to SOFR," preparations should at a minimum include assessing the different risk exposures across an institution as to both new and existing transactions that will survive the transition; identifying and quantifying any potential risks associated with any required amendments to agreements; and ensuring that the risks and mitigation plans are communicated throughout the organization to ensure it is prepared as a whole, especially for large institutions with multiple departments and offices.

Implications for Financial Institutions

The NYDFS Industry Letter is addressed to "regulated institutions," including depository institutions (including banks, credit unions and savings associations), non-depository financial institutions (including licensed lenders, sales finance companies and premium finance companies, mortgage companies, money transmitters and virtual currency companies), and property, health and life insurance companies. At a minimum, this would appear to cover all such institutions licensed or chartered by the NYDFS, including the branches of non-US banks licensed by the NYDFS (although they are not expressly mentioned in the Industry Letter), money transmitters and BitLicense holders. It is less clear whether the Industry Letter is intended to apply to all financial institutions conducting business in New York. This broader interpretation would seem unlikely given that federal preemption would presumably preclude the NYDFS from requiring a submission from national banks, federal savings associations or federally-licensed branches of non-US banks.

Regardless of whether a financial institution is required to submit a plan to the NYDFS, any financial institution in the United States with existing LIBOR exposure should be aware that the federal banking regulators are also increasing their oversight of LIBOR transition plans. The OCC, in its latest Semiannual Risk Perspectives publication, noted that "[e]xaminers will evaluate whether banks have begun to assess their exposure to Libor in assets and liabilities to determine potential impacts and develop risk management strategies."[2] In a 2019 speech, FRB Vice Chair for Supervision Randal Quarles said that examiners would use a tailored approach to LIBOR transition examinations and expects to see "an appropriate level of preparedness" that "must increase" as the end of 2021 grows closer, and that examiners had begun to include "detailed questions" in their examinations of large firms on their plans to transition away from LIBOR.

For institutions required to respond to the NYDFS by February 7, care should be taken to coordinate responses with any other existing or planned disclosures to regulators or the public. Public companies, for example, should seek to align public disclosures regarding LIBOR transition plans with their NYDFS responses. In addition, nonbanks licensed in multiple states should consider and anticipate that other state licensing authorities will request LIBOR transition plan information, whether through formal submissions or in the course of regular examinations.

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2 National banks will be expected to be able to: produce an accurate inventory of balance sheet assets and liabilities and off-balance sheet contracts that may be affected by a movement to an alternative rate, including assets serviced by third parties and financial instruments acquired during a merger or acquisition that may not be included in the bank's primary systems; assess compliance and reputational risks associated with moving clients to a new and untested index, including an analysis of customer impact, repapering contracts, updating system applications, revising and testing models and ensuring appropriate contractual fallback language and disclosures to clients; make disclosures to consumers related to consumer products, such as adjustable rate mortgages, private student loans, credit cards, reverse mortgages and HELOCs that are "easily comprehensible for consumers and investors"; establish "observable, objective rules" to minimize expected pricing issues before LIBOR cessation; and assess whether third-party service providers are on track to modify their systems.

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