Regulatory Notice 20-26

LIBOR

FINRA Shares Practices Firms Implemented to Prepare for the LIBOR Phase-out

Summary

FINRA reminds firms to evaluate their exposure to LIBOR (formerly, the London Interbank Offered Rate), and review their preparedness to manage LIBOR's phase-out. To understand how firms are preparing for that phase-out, FINRA surveyed a representative cross-section of member firms, including some firms with significant trading volume or positions in LIBOR-linked securities. This *Notice* provides a summary of the results of the survey.

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Background

LIBOR has been used for many years as a benchmark for global interest rates that impact trillions of dollars of financial instruments.[1] Following the 2008 financial crisis, financial regulators and industry in the United States and United Kingdom began a process to replace U.S. Dollar (USD) LIBOR with alternative benchmarks. In 2017, LIBOR's regulator—the United Kingdom's Financial Conduct Authority (FCA)—announced that banks would no longer be compelled to submit LIBOR data after December 31, 2021 (the phase-out date).[2]

With an estimated $35 trillion of USD LIBOR-based contracts extending after the phase-out date, the movement away from LIBOR may have significant implications for financial market participants, including broker-dealers, their customers and counterparties. In addition, although this *Notice* focuses primarily on LIBOR, broker-dealers or their customers may also be exposed to the parallel discontinuation of other interbank offered rates (IBORs) such as the Euro Interbank Offered Rate (EURIBOR) or Tokyo Interbank Offered Rate (TIBOR).

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Notice Type
- Guidance

Suggested Routing
- Compliance
- Information Technology/Systems
- Legal
- Operations
- Risk Management
- Senior Management
- Trading

Key Topics
- Derivatives
- Interest Rates
- LIBOR
- LIBOR-based Contracts and Debt Instruments
- LIBOR-linked Securities
- LIBOR Phase-out

The phase-out of LIBOR, and discontinuation of other IBORs, may increase broker-dealers' exposure to risks relating to compliance requirements, adverse financial and accounting issues, disruptions to business operations, and related litigation with customers, counterparties or third-party providers. In light of these potential risks, FINRA identified the phase-out as one of our risk monitoring and examination priorities in 2020, noting that we would engage with firms—outside the examination program—to understand how they are preparing for LIBOR's phase-out.[3]

This *Notice* highlights the results of one element of that engagement, a survey FINRA conducted on firms' preparedness for the phase-out and the scope of their ongoing efforts to develop and implement programs to address risks relating to the phase-out.[4] FINRA surveyed a representative cross-section of the FINRA membership, including firms with significant trading volume or positions in LIBOR-linked securities.[5]

The survey found that while some large firms, notably large brokers-dealers affiliated with bank holding companies, had implemented extensive programs to prepare for the phase-out, others had made only limited efforts.

FINRA reminds firms to evaluate their exposure to LIBOR and review their preparedness efforts to manage LIBOR's phase-out. Exposure to LIBOR could include, for example, firm or customer holdings of securities or contracts referencing LIBOR that mature after the phase-out date or references to LIBOR in a firm's financial models, such as market, credit or liquidity risk models.

This *Notice* does not represent a comprehensive inventory of approaches to preparing for the phase-out, nor is it intended to set forth exam findings or FINRA's view of specific effective practices. Firms may wish to consider whether the practices described below are applicable to their own circumstances and would enhance their risk management, supervisory systems and compliance programs; however, there should be no inference that FINRA requires firms to implement any specific practices described in this *Notice* or those that extend beyond the requirements of existing securities rules and regulations.

Considerations for the LIBOR Phase-out

The following questions, in conjunction with the summary of survey responses shared below, may help firms evaluate their efforts to prepare for the phase-out.

- Has your firm evaluated the impact of the phase-out on your business, customers, counterparties, products and vendors and developed a plan to prepare for the phase-out?
- Can your firm measure its own exposure to LIBOR-linked products that expire after the phase-out date?
- Can your firm identify LIBOR-linked products that expire after the phase-out date in accounts customers hold at the firm?

- Has your firm evaluated potential risks related to fallback provisions (or the absence of such provisions) for securities and contracts referencing LIBOR and expiring after the phase-out date? These risks could include, for example, declining liquidity in the market for such instruments close to and after the phase-out date.
- Has your firm identified business processes, systems and vendors that may be affected by the phase-out, and developed plans to mitigate operational risks arising from the phase-out?
- Has your firm engaged in opportunities industry organizations have provided to learn about effective practices for transitioning to alternative reference rates to replace LIBOR, as well as other IBORs?
- Has your firm trained your associated persons and other staff about the potential impact of the phase-out on your firm's customers?
- Has your firm prepared guidance for associated persons and other staff relating to communicating to customers the impact of the phase-out for your firm, your firm's clients and customers and any LIBOR-linked products that expire after the phase-out date?
- How is your firm preparing to supervise associated persons' recommendations relating to LIBOR-linked products?

Summary of Survey Results

1. **Governance Framework**

   Firms that developed and implemented governance frameworks to manage the LIBOR phase-out have begun or plan to begin:

   - assigning responsibility for preparing for and managing the phase-out to specific business units (*e.g.,* Treasury or Risk), project teams, project management offices (PMOs) or other *ad hoc* committees;
   - including relevant staff from departments across the firm (*e.g.,* Legal, Compliance, Risk, Technology, Operations and business units) in phase-out planning efforts to provide a cross-functional view on the potential impacts of the phase-out; and
   - developing and implementing comprehensive phase-out plans that:

     I. identify policy, organizational, process and information system change requirements for the post-phase-out operating environment;

     II. identify dependencies across change management plans and measure progress towards achieving those goals; and

     III. set timelines with required interim deliverables (while also providing for flexibility to accommodate potential changes to phase-out requirements).

2. **Financial Risk**

Firms that evaluated their financial risk exposure to LIBOR and other IBORs have begun or plan to begin:

- identifying their inventory, as well as their customers' holdings, of products and contracts maturing or planned to be rolled over after the phase-out date;
- classifying these exposures into categories such as:
  - I. derivatives products (including over-the-counter (OTC) derivatives with affiliates or third parties and exchange-traded derivatives);
  - II. cash products (including corporate and municipal bonds, as well as securitized products, such as mortgage-backed securities (MBS) and collateralized loan obligations (CLOs)); or
  - III. other products or contracts (including structured repos,[6] margin loans or term loans, including subordinated loans, to the broker-dealer from affiliates); and
- estimating firm and customer gross notional exposure for products and contracts maturing or planned to be rolled over after the phase-out date.

3. **Operational Risk**

Firms that assessed their operational risk exposures have begun or plan to begin:

- developing an inventory of business processes, business units, information systems and vendors that would be impacted by the phase-out, including front, middle and back-office functions;
- conducting an inventory of market, credit and liquidity models that reference LIBOR (or other IBORs), identifying appropriate alternate reference rates (as discussed in item 4, Alternative Reference Rates) and testing them with the appropriate new reference rate(s); and
- determining responsibility between introducing and clearing firms for operational functions impacted by the phase-out (such as incorporating the new reference rate into firm account statements).

4. **Alternative Reference Rates**

Firms that reviewed and identified options for alternative reference rate to replace LIBOR and other IBORs have begun or planned to begin:

- participating in, or following the work of, industry organizations—*e.g.,* the International Swaps Dealer Association (ISDA), the Alternative Reference Rates Committee (ARRC)—to further understand recommendations and protocols for adopting alternative reference rates, as well as learn about other firms' solutions for managing some of the most challenging issues the phase-out poses; and
- considering alternative rates (in addition to SOFR), which include, but are not limited to, other risk-free rates, such as SONIA, TONAR, ESTER and SARON.[7]

5. **Legal Risk**

Firms that reviewed their exposure to legal risks arising from reference to LIBOR or other IBORs in securities and other contracts have begun or plan to begin:

- conducting an inventory of all contracts impacted by the LIBOR phase-out, including by, in some cases, leveraging advanced, scalable technology solutions, such as machine learning and artificial intelligence, to support their contract inventory and review; and
- reviewing or developing fallback language, and renegotiating and repapering contracts, including leveraging resources from ARRC and ISDA.

6. **Staff Training and Customer Education**

Firms that engaged in educational opportunities and provided additional guidance about the phase-out to their staff, customers and counterparties have begun or plan to begin:

- training client-facing office and other staff about firm plans and related implications of the phase-out (including in-person training, webinars, emails, podcasts, FAQs and town hall discussions);
- developing centralized, internal knowledge-sharing sites for resources, communication and guidance relating to the phase-out;
- communicating with customers about the firm phase-out timeline, as well implications for customers' products; and
- providing disclosures on firm websites and customer communications about the phase-out, including its impact on customers, counterparties, third parties and products.

Additional Resources

The following information sources may be helpful for firms seeking additional information about LIBOR and the phase-out:

- Financial Stability Board, Reforming Major Interest Rate Benchmarks (July 22, 2014)
- U.S. Securities and Exchange Commission Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant Staff Statement on LIBOR Transition (July 12, 2019)
- U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Examination Initiative: LIBOR Transition Preparedness (June 18, 2020)

Endnotes

1. LIBOR is a benchmark interest rate used by major global banks to lend to each other in the international interbank market for short-term loans. LIBOR is quoted in seven maturities (overnight, one week, one month, two months, three months, six months and 12 months) across five currencies (Swiss franc, euro, pound sterling, Japanese yen and U.S. dollar), which amounts to 35 different LIBOR rates reported each business day.

2. U.S. financial regulators have been working closely with industry groups and other stakeholders through the Alterative Reference Rates Committee (ARRC) to establish a new reference rate to replace USD LIBOR. On June 22, 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as its recommended reference rate to replace USD LIBOR. *See, e.g.,* Transition from LIBOR, available on the website of the Federal Reserve Bank of New York.

3. *See* FINRA's 2020 Risk Monitoring and Examination Priorities Letter (Jan. 9, 2020) (noting that FINRA will engage with firms—outside the examination program—to understand how the industry is preparing for LIBOR's retirement at the end of 2021, focusing on firms' exposure to LIBOR-linked financial products; steps firms are taking to plan for the transition away from LIBOR to alternative rates, such as SOFR; and the impact of the LIBOR phase-out on customers).

4. *See also* FINRA's blog, "Conversations about Libor: Discussing the Past, Present and Future of the World's Most Important Number."

5. In selecting the sample, FINRA considered a number of factors, including firm size, affiliation with a bank holding company, and regulatory oversight by other U.S. or foreign agencies. FINRA collected data from approximately 40 firms, with broad representation of the membership based on size and business models.

6. Some firms reported repos with embedded derivatives linked to LIBOR.

7. Sterling Overnight Interbank Average Rate (SONIA), Tokyo Overnight Average Rate (TONAR), Euro Short-Term Rate (ESTER), Swiss Average Rate Overnight (SARON).