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FINANCIAL SERVICES

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What Happened to My Interest Rate? Fed Intensifies Scrutiny of Lenders' SOFR Transition Efforts

In recent weeks, U.S. banks have been receiving inquiries from the U.S. Federal Reserve System (the "Fed") in connection with the banks' current London Inter-Bank Offered Rate ("LIBOR") exposure, plans for amendments which add fallback rates to current contracts, and the status of fallback provisions for alternate rates, namely the Secured Overnight Financing Rate ("SOFR"). Industry analysts believe that this move is intended to provide the banking industry with a sense of urgency and to demonstrate the importance of an orderly LIBOR transition from the Fed's perspective.

BACKGROUND

It is perhaps unsurprising that the Fed has enacted a campaign to encourage and speed up the LIBOR transition – currently only a small number of the contracts governing the $200 trillion derivatives market have shifted to SOFR. In fact, there are potentially hundreds of billions of dollars in the form of LIBOR-based floating-rate notes and securitizations that will be difficult or impossible to transition to an alternative rate structure. The rate risk presented in the current universe of LIBOR based products has given the Fed concerns of significant risks to financial stability.

CURRENT FED INQUIRY EFFORTS

Previously, on November 30, 2020, the Fed, along with the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"), released a statement announcing that they will no longer allow LIBOR-pegged contracts for any bank without "robust fallback language" and preferably a clearly defined alternative reference rate."[1] In furtherance of this expectation, the Fed has been providing written questions and requests for data to financial institutions, targeting bulge bracket banks and regional lenders. They have supplemented these efforts as well by sending Fed representatives to meet with these lenders. Typical inquiries request detail on the maturity timelines for LIBOR-based

contracts, status updates on current transitions efforts, and a myriad of other requests for data related to particular forms of LIBOR exposure.

POTENTIAL ADDITIONAL FED SCRUTINY

Given the current trajectory, the Fed may intensify efforts as they attempt to grasp the scope of lender exposure to LIBOR transition risks. Fed representatives have additional tools to encourage detailed answers and lender compliance through the use of Matters Requiring Attention ("MRA") or Matters Requiring Immediate Attention ("MRIA"). Each of these devices are a form of communication used by bank regulators to provide criticisms to bank management. MRAs and MRIAs are issued as part of the examination process to gather information and provide guidelines for remediation. Fed MRAs and MRIAs stemming from the LIBOR transition could require extensive information that is time-consuming to gather and may even require the implementation of transition planning.

CONSIDERATIONS FOR LENDERS

Wall Street banks and regional lenders alike should consider the current Fed trend a wake-up call to review their existing contracts with LIBOR reference rates as well as to develop a transition plan. Although the Fed has delayed the phase-out of certain LIBOR maturities until mid-2023, institutions cannot rest on their laurels and avoid regulatory scrutiny. In order to avoid Fed scrutiny and the use of MRAs/MRIAs, lenders should be proactive in their efforts to amend LIBOR-based contracts and progress in their transition planning. The Alternative Reference Rates Committee (the "ARRC") has provided SOFR fallback language and a variety of transition recommendations, which may be beneficial for lenders to review and implement as the Fed continues its push towards the transition. Ultimately, in light of the Fed's scrutiny, institutions should take meaningful steps towards the alternative rate transition.

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[1] Board of Governors of the Federal Reserve System, FDIC, & Office of the Comptroller of the Currency "Statement on LIBOR Transition" (November 30, 2020). https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf