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The Next Stage in the LIBOR Transition
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Remarks by

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at the

Alternative Reference Rates Committee Roundtable, cohosted by
the Alternative Reference Rates Committee and
the New York University Stern School of Business and Its Salomon Center
for the Study of Financial Institutions

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Good morning to you all. I am sorry I cannot be present at the Alternative Reference Rates Committee's (ARRC) fourth roundtable, but I wanted to share these remarks with you at what is the start of the next critical stage in the transition away from LIBOR.[1]

Since 2014, the official sector has publicly warned that LIBOR could become unstable. Not everyone paid attention to those warnings, but the risks that we pointed to have materialized. The U.K. Financial Conduct Authority has intervened to preserve LIBOR's stability only through the end of 2021. Despite that development, some continue to speculate that LIBOR can remain in production indefinitely. My key message to you today is that you should take the warnings seriously. Clarity on the exact timing and nature of the LIBOR stop is still to come, but the regulator of LIBOR has said that it is a matter of *how* LIBOR will end rather than *if* it will end, and it is hard to see how one could be clearer than that.

The Federal Reserve convened the ARRC based on our concerns about the stability of LIBOR. The ARRC was charged with providing the market with the tools that would be needed for a transition from LIBOR: an alternative rate that did not share the same structural instabilities that have led LIBOR to this point, a plan to develop liquidity in the derivatives market for this new rate so that cash users could hedge their interest rate risk, and models of better contract language that helped limit the risk from a LIBOR disruption.

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[1] Vice Chair for Supervision Quarles also serves as Chair of the Financial Stability Board. The remarks represent his own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

The ARRC has provided these tools. Now it is up to you to begin using them. With only two and a half years of further guaranteed stability for LIBOR, the transition should begin happening in earnest. I believe that the ARRC has chosen the most viable path forward and that most will benefit from following it, but regardless of how you choose to transition, beginning that transition now would be consistent with prudent risk management and the duty that you owe to your shareholders and clients.

The ARRC's work began by focusing on creating a derivatives market for the Secured Overnight Financing Rate (SOFR), its recommended alternative to U.S. dollar LIBOR, because end users require derivatives markets to hedge their cash exposures. The CME Group, LCH, and Intercontinental Exchange, or ICE, all now offer futures or swaps markets on SOFR, and participation in these markets is growing. As liquidity in these markets continues to develop, my hope is that many of you will avail yourselves of them to close out your LIBOR positions. In the meantime, it will be crucial in ensuring global financial stability that everyone participate in the International Swaps and Derivatives Association's (ISDA) consultations on better fallback language for LIBOR derivatives and then sign the ISDA protocol so that these fallbacks apply to the legacy book of derivatives.

Likewise, the ARRC has now offered better fallback language for new issuance of cash products that refer to LIBOR. It seems clear that much of the contract language being used currently did not envisage and is not designed for a permanent end to LIBOR. The ARRC's fallback recommendations represent a significant body of work on the part of a wide set of market participants and set out a robust and well-considered set of steps that expressly consider an end to LIBOR.[2] I urge everyone to avail themselves of this work; it is, again, important for prudent risk management and your fiduciary responsibilities that you incorporate better fallback language. Issuers should demand it of themselves, and investors should demand it of issuers.

There is, however, also another and easier path, which is simply to stop using LIBOR. At this moment, many seem to take comfort in continuing to use LIBOR—it is familiar, and it remains liquid. But history may not view that decision kindly; after LIBOR stops, it may be fairly difficult to explain to those who may ask exactly why it made sense to continue using a rate that you had been clearly informed had such significant risks attached to it. And make no mistake—as good as the fallback language may be, simply relying on fallback language to transition brings a number of operational risks and economic risks. Firms should be incorporating these factors into their projected cost of continuing to use LIBOR, and investors and borrowers should consider them when they are offered LIBOR instruments. If you do consider these factors, then I believe you will see that it is in your interest to move away from LIBOR.

In convening the ARRC, we have set a model of public-private sector cooperation to address a key financial stability risk. Ultimately, the private sector must drive this transition—these are private contracts, and each of you must choose how you can best address this risk—but the public sector must help. At a recent roundtable on the LIBOR transition held by the Financial Stability Board, we heard calls from the private sector to provide greater clarity on regulatory and tax implications of the transition and also calls for a more “muscular” regulatory approach.

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[2] The ARRC’s recommendations for fallback contract language can be found at https://www.newyorkfed.org/arrc/fallbacks-contract-language.

It is incumbent on the official sector to take these requests seriously, and we are. For example, the Federal Reserve is working with the Commodity Futures Trading Commission and other U.S. prudential regulators to provide greater clarity on the treatment of margin requirements for legacy derivatives instruments. Agency staff are developing proposed changes to the margin rules for non-cleared swaps to ensure that changes to legacy swaps to incorporate a move away from LIBOR, including adherence to the ISDA protocol, would not affect the grandfathered status of those legacy swaps under the margin rules. This has been a key request of the ARRC, and we will look forward to public comment on the proposal.

The Federal Reserve's supervisory teams have already included a number of detailed questions about plans for the transition away from LIBOR in their monitoring discussions with large firms. The Federal Reserve will expect to see an appropriate level of preparedness at the banks we supervise, and that level must increase as the end of 2021 grows closer. Our supervisory approach will continue to be tailored to the size of institution and the complexity of LIBOR exposure, but the largest firms should be prepared to see our expectations for them increase. As we consider the answers we have received from these firms, we will assess how our supervisory expectations for them should evolve in the coming year.

Let me address one additional point relating to our supervisory stress tests, in an effort to provide further clarity. Some have recently claimed that the Federal Reserve's supervisory stress tests would penalize a bank that replaces LIBOR with SOFR in loan contracts by lowering projections of net interest income under stress. As can be seen in our recently published enhanced descriptions of the supervisory stress-test models, the interest rate variables that drive projections of net interest income under stress are the yield on 10-year Treasury bonds, the yield on 3-month Treasury bills, and the 10-year triple-B corporate yield.[3] That is, the supervisory projections of net interest income are primarily based on models that implicitly assume that other rates such as LIBOR or SOFR move passively with short-term Treasury rates. Given these mechanics, choosing to lend at SOFR rather than LIBOR will not result in lower projections of net interest income under stress in the stress-test calculations of the Federal Reserve.

I hope I have been able to provide you with some further clarity today. I am sure that the rest of the roundtable will do so as well. I want to applaud the members of the ARRC who are working hard to make sure this threat to financial stability is avoided.

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[3] See Board of Governors of the Federal Reserve System (2019), *Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Methodology* (Washington: Board of Governors, March), table 2, p. 23, https://www.federalreserve.gov/publications/files/2019-march-supervisory-stress-test-methodology.pdf.