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Nine Really Difficult Things to do for Managing the USD LIBOR Transition

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The Federal Reserve's Alternative Reference Rates Committee, which is coordinating the U.S. effort to transition away from USD LIBOR, recently published the "Buy-Side/Asset Owner Checklist" to help firms organize their transitions away from USD LIBOR instruments.

https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Buy_Side_Checklist.pdf

The checklist contains 72 broad goals under 10 general categories, ranging from communications within the firm to tax accounting, but emphasizing project planning and risk assessment.

You may think, "my firm buys market instruments, so I'll just buy what's out there and agree to industry language to change the floating rate for legacy investments." However, even if that is your firm's strategy, we have identified nine recommendations set out below from the checklist which you should nonetheless focus on and which will probably give you headaches over the next 12 months.

Implementation Checklist – Selected Recommendations	
Exposure management and valuation	
Recommendations 4.4 and 4.6	Ensure that valuation models using LIBOR-based curves are able to handle new curves using new indices, including SOFR / alternative rates. Construct / obtain access to a SOFR interest rate curve to be used for pricing SOFR-based products, calculating interest on USD collateral, and discounting USD-denominated derivatives. Firms are advised to confirm vendor system readiness for pricing and risk analytics, as appropriate.
Portfolio and product strategy	
Recommendation 5.3	Define risk and new fund/investment approval requirements for SOFR-linked funds/products/benchmarks.
Risk management	
Recommendation 6.2	Establish processes to measure and monitor the identified material risks under baseline and alternative transition scenarios (e.g., market adoption, product and currency liquidity, current and stress market conditions, internal and external system readiness, vendor preparedness, regulatory consequences, performance impacts, hedge mis-match, client concerns).

Recommendation 6.6	Assess impact to LIBOR-linked risk models and develop processes for updating including guidelines for validation requirements.
Contractual remediation	
Recommendation 7.5	For existing contracts and benchmarks that reference LIBOR, define approach and prioritization strategy for renegotiating / repapering where needed. *Decide whether the eventual ISDA protocol will work for amending existing LIBOR-linked contracts. If not, be prepared to choose among the extremely complex "enhanced fallback" language proposed by the ARRC, each dealer's preferred language, or copying the ISDA protocol language. Dealers and banks are likely to take the initiative here, but watch out for last-minute demands to amend everything in a hurry or to demand non-industry standard terms.*
Recommendation 7.5	Following FASB and tax guidance, begin either (a) amending contracts to include language that will not trigger adverse tax or accounting consequences, or (b) determining if contracts can be renegotiated or closed out prior to end-2021 to avoid adverse consequences.
Operational and technology readiness	
Recommendation 8.12	Firms that have cleared swaps should familiarize themselves with CCP plans to transition the discounting and PAI in USD-discounted products to SOFR.
Accounting and Reporting, including Investment and Client Accounting	
Recommendation 9.7	Determine 1940-Act Fund Accounting implications of fallback conversions on the NAVs of affected share-classes, as well as of an ongoing multi-rate environment.
Taxation and Regulation	
Recommendations 10.1 and 10.2	Determine tax accounting and compliance implications including, but not limited to, (a) whether or not the fall back transition is a taxable event, (b) implications of taxable gain / loss to debt holders, swap counterparties, general account assets, and investment clients and (c) tax impact of hedge accounting based on current guidance and industry requests to IRS, and any necessary documentation changes.

Despite all that is going on right now, we will continue to monitor USD LIBOR replacement and will provide further updates as they become available. Questions regarding the matters discussed in this update may be directed to either Joseph Heyison at joe@charleslawpllc.com or GuyLaine Charles at guylaine@charleslawpllc.com. This client update is prepared for the general