



Approaching Cessation: The LIBOR Transition Confronts the Pandemic of 2020

Methodology

Sia Partners is issuing its third report over the past year, outlining an assessment of the current state of the market transition from the London Interbank Offered Rate (LIBOR) to alternative overnight risk-free rates. This report focuses on the challenges the industry has faced amidst the current market disruption caused by the COVID-19 pandemic beginning in March 2020. Our initial report, which we shared at the end of 2019, was published in conjunction with Cadwalader, Wickersham & Taft. Sia Partners followed that report in the first quarter of this year with individualized summaries and discussions with numerous market participants based on our collective work and research. This third report was both survey- and interview-based and was conducted between April and June of 2020. We utilized a comprehensive questionnaire, which more than 70 market participants completed. The interviews included subject-matter experts from a variety of functions, including legal, risk management, compliance, operations, finance and information technology, along with those charged with directing LIBOR transition efforts at those firms. Below we provide a specific breakdown of the nature of the respondent base.

Consistent with our prior work, the identification of those institutions and their feedback is confidential and non-attributable. Participants included a broad and diverse range of financial institutions, both buy and sell-side firms, reflecting cash and derivative products in wholesale and retail markets. This included, as in our past work, U.S. and foreign global systemically important banks and non-U.S. with a substantial U.S. presence. The project also included a meaningful number of U.S. regional and super-regional banks and several smaller U.S. community banks. We also included a group of asset managers, insurance companies and fund managers as well as diverse and alternative investor entities. Our participants included a group of wealth managers, private banks and securities-based lenders that participated with the encouragement of the Securities Industry and Financial Markets Association, which we deeply appreciated. We also included a small set of third-party vendors, law firms, and research firms whose contributions and input were valued. Lastly, we want to express our appreciation to our partner colleagues at Cadwalader and Eigen Technologies who shared their feedback on their exchanges with the market, which we have included in our report.

Consistent with the report conducted in December, the final project results will only be shared with the participating firms. A summary of our findings will be more broadly available to non-participants and social media.

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Executive Summary

INTRODUCTION

In December of 2019, Sia Partners published a detailed, global benchmarking study examining the state of the LIBOR Transition among leading global financial institutions at year-end. Through mid-March, we met individually with over 50 of those participants to exchange views on their challenges and anticipated progress in 2020. With the onset of the COVID-19 pandemic and accompanying market disruption, we undertook a new effort to baseline the impact of these unprecedented events through early June 2020.

Over the past ninety days, the world financial markets have been asked to progress through this transition while confronting a deadly virus, periodic market dislocations and most recently as we publish, social unrest all complicating economic progress. The past three months required an immediate departure out of offices and a prioritization of health and safety of families and co-workers unseen in recent times. Our report found that participants used this opportunity to reconcile the enormous magnitude of the transition undertaking at all levels within their institution, and much of 2020 will be virtual to progress the transition. Participants shared the enormity of the challenges, meeting the certain cessation dates at the end of 2021 and doing so in a very complex environment. We summarize in our report the key findings that have come from our research and insight as to how best to address their challenges over the next 18 months and ahead.

RESPONDENT BREAKDOWN

Institution Type Peer Groups	% of Respondents
Bank – Global Systemically Important Bank (G-SIBs)	22%
Bank – Non-Global Systemically Important Bank (Non-G-SIBs)*	31%
Non-Bank Financial End-Users	23%
Private Client/Wealth Management	14%
Vendor	10%
Grand Total	100%

*U.S. Regional Banks and Foreign Non-G-SIB Banks

Geographical Peer Groups	% of Respondents
U.S. Headquartered Institutions	58%
Non-U.S. Headquartered Institutions	42%
Grand Total	100%

PANDEMIC INDUCED FACTORS

Beginning in early March, participants were required to quickly evolve to Working from Home (WFH) arrangements and implementing business continuity efforts across the near entirety of business and operations groups. These shifts included their LIBOR transition efforts and interactions with clients, vendors and third parties. Participants discerned the difference between the effects of the pandemic and the effects of the shorter-term financial disruption caused by the pandemic. Nearly 90% of all participants from our

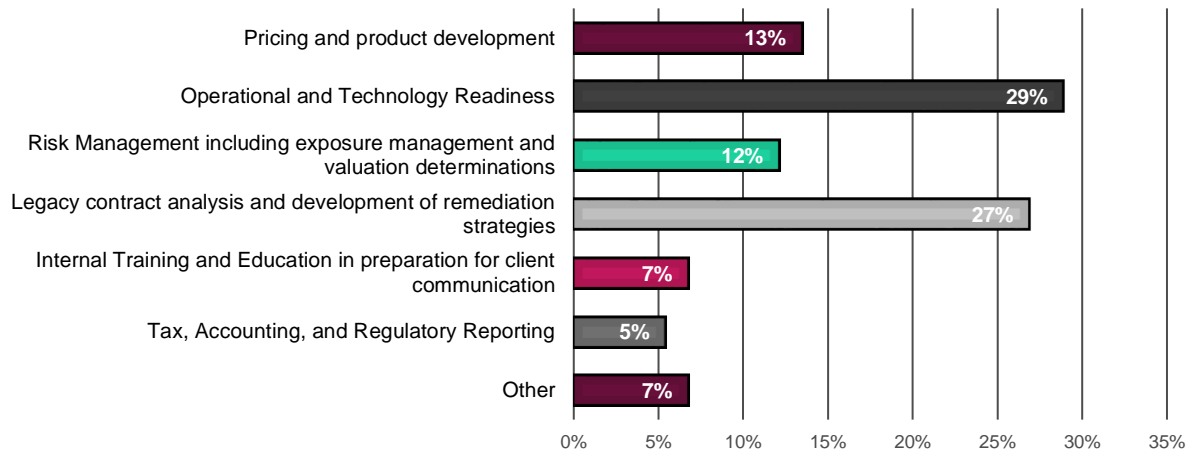
research indicated either no impact or only short term, temporary resource re-allocation stemming from the pandemic. This was ascribed to a brief period of time dedicated to transitioning to WFH arrangements combined with re-allocating resources during the period of substantial market volatility. LIBOR budgets stayed the same across all types of participants; attention to governance and oversight also did not change. Once in place, the respondents noted that their productivity was equal to and in a few cases greater than it was before. The exception to this was for smaller institutions that identified a lengthier impact on some of their transition work-streams and a lengthier re-allocation of their resources. Importantly, however, most institutions emphasized that challenges including the integration of the work of their vendors, interaction with their client and remediation efforts and a variety of operational challenges remained.

TRANSITION EFFORT PROGRESS

Respondents noted the prior quarter had given sharp focus to the meaningful transition challenges each firm and the industry at large has and will continue to face during over the next year and a half. Participants focused in particular on the heavy lifts required across operational, risk, infrastructure, systems re-tooling, interactions with critical third parties, meeting governance guidelines among a myriad of other issues. In particular, those firms with larger cash product portfolios and a preponderance of commercial and middle-market lending clients identified an array of transition initiatives for upgrading their loan and lending platforms to meet new reference rate protocols. Participants also pointed to progress being made both in the U.S. and UK/EMEA among the various working groups and the Alternative Reference Rates Committee (ARRC), including the most recently issued re-iteration of the cessation dates and proposed market practices that have accompanied them. Finally, respondents in our conversations spoke about new initiatives in the operations and vendor working groups. Many if not all of these issues were identified in a more preliminary manner in our study last year and then re-visited in our meetings in the winter/early spring of this year with many of those same firms. As we note above, the pandemic did not create meaningful new challenges for the vast majority of the participants at all levels of size and sophistication. The operational aspects of “working from home” seemed to perform well for the vast majority of participants. However, many identified that the pandemic created a transition “treading in water” on some issues for multiple weeks and the ability to multi-task effectively often took several additional weeks to achieve. Hence, the challenges of yesterday were, for most, the challenges of today, but now with at least three fewer months to address them. Specifically, when comparing our prior study benchmarking results from late last year, we found that legacy contract analysis, price and product clarity, vendor dependencies, risk management and operational and technology readiness were the items isolated across the board as the most troublesome obstacles in the transition to overcome. Over 85% of the participants identified some combination of these issues as top of mind for them to address

The larger causes for concern did not stem directly from the pandemic itself, but the resulting market instability which immediately raised questions as to the plausibility of the transition occurring as planned. As evident from our previous studies done before the pandemic, however, it is clear that there was a lack of progress among participants. Because of the length of the process overall, the absence of very clear progressive steps and a lack of urgent motivating forces, there was a lesser feeling of immediacy than perhaps was appropriate. We have found among various sizes and types of respondents when determining the weight of pandemic induced challenges that many, if not all, also gained a better understanding of the weight of pre-pandemic challenges.

BEFORE THE ONSET OF THE PANDEMIC, WHAT TRANSITION ACTIVITIES WERE PRESENTING YOUR ORGANIZATION WITH THE MOST SIGNIFICANT CHALLENGES?



INDUSTRY TIMELINES AND POLICYMAKER RESPONSES

Over the past several months both the Financial Conduct Authority (FCA) and the ARRC (among other bodies) have evaluated the capacity of financial institutions to meet the year-end 2021 LIBOR cessation deadlines while implementing a decent portion of that transition in 2020 in a virtual manner. The issuance by both bodies of policy documents, during May, joined by the Federal Reserve and other regulatory bodies, both clarified and reiterated that the cessation date has not changed. Respondents agreed that this reaffirmed the operational, legal and commercial need for certainty, and retrospectively, that the vast majority of the industry could continue to invest to meet that deadline. There was broad recognition in our project that various milestones have and will likely continue to move to ensure sufficient time to meet most if not all the requirements. Report participants joined regulators and policymakers recognizing the importance of this transition succeeding in a timely manner and the costs in time, resources and capital were it to move would be damaging. The data we highlight in our report is quite clear: a small minority of the firms expected a delay in the cessation; less than a quarter wanted a delay in that date. A majority of firms anticipated and wanted some milestone delays (LCH, swaps discounting, consumer cash and non-cash products) reflecting the continued challenge posed by the reliance of many firms on third parties to assist with the implementation of those guidelines. While challenging, most of the respondents said they were on pace in terms of operational and technological readiness; a few smaller firms saw the transition timeline as too aggressive to meet. Less than 10% of foreign banks, G-SIBs or U.S. regional banks expected a change in the cessation date; about 15% of foreign banks and G-SIBs wanted some relief on the cessation date. However, a third of the U.S. regional banks, mirroring their broad spectrum in size, product utilization, investment to date in the transition, reflected a desire to push back the cessation date. Finally, a majority of participants agreed that the consideration by policymakers of certain risk-free rate components, including forward-looking term and dynamic credit sensitivity, could assist some entities in their transition. A quarter of the participants viewed one of these components as a vital contributor to the success of their program, a finding that was consistent with our prior exchanges on this topic.

This combined feedback reflected a conundrum: you were invested to meet the deadlines, you would not mind more time if it was given to you, and constituencies within your institution might have differing views. Depending upon the institution’s business model, a distinctly smaller set of commercial banks and/or middle market clients had more confidence in meeting the deadlines. Those, by definition that were more third-party resource reliant, or with larger cash and consumer product businesses, found greater obstacles. Non-U.S. institutions, some of which have been focused on their transition for a year or longer than their U.S.

counterparts, found meeting imposed deadlines, in a different and more regulatory-driven environment, generally easier to accomplish.

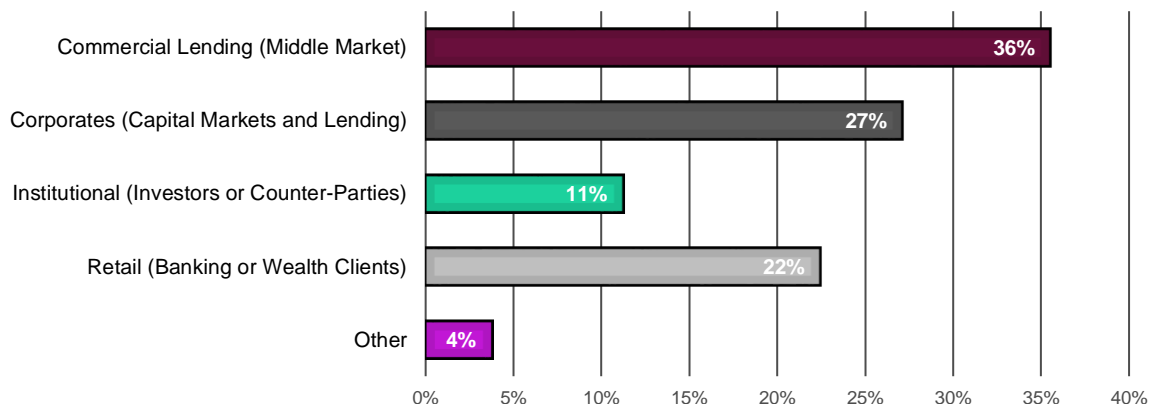
Finally, although somewhat undeveloped, our report found that a large majority of our participants considered some type of legislative relief to be of importance in resolving their transition issues. Respondents identified the proverbial enhanced certainty surrounding legacy contract analysis, remediation strategies and the clarification of replacement rates as priority items. Participants noted the potential challenges of a separate legislative/regulatory environment in the U.S. vs. the UK vs. EMEA has requiring redress were either U.S. state and/or federal legislative passed and similar undertakings not attempted or achieved elsewhere.

CLIENTS

Participants in all our projects and individual discussions have identified the myriad of issues surrounding client communication, contract remediation and ensuring transition progress from counterparties as being the greatest obstacle in meeting transition deadlines. In our discussions over the past year and multiple reports and papers related to those exchanges, resolution of the complex issues surrounding client/counterparty progress have been identified as the most vexing issue to resolve. Project participants pointedly noted that without meaningful client participation there will be no transition. This reflection was not only seen in all of our research and meetings prior to this report, but also across all client classes, size, sophistication, product utilization and geographic location. Respondents noted that the challenges were numerous—not only the oft mentioned issues relating to legacy contract analysis, the use of additional resources and Automation or NLP as a potential accelerator, but also the requirement to begin the process of review and customization of new products for all those clients. Smaller institutions were generally less progressed specific to client communication prior to the pandemic, which often resulted in the re-prioritization of resources and shifted focus caused by the pandemic. This is likely to put additional timeline pressure on these organizations. For regional banks, nearly 50% of the respondents identified additional resources for work-streams, increased pre-remediation analysis and potential utilization of AI/NLP as important approaches to enhance client outreach. Over 60% of G-SIBs along with nearly two-thirds of foreign banks identified those identical issues to furthering their efforts. Industry feedback has suggested that those who are effectively using technologies such as NLP and automation in a strategic manner are among those best placed to meet internal transition deadlines surrounding legacy contract analysis and pre-remediation due diligence. As we have heard from market participants, timely and accurate analysis and due diligence can help mitigate potential risks including economic and conduct risk. Finally, respondents have noted that some regulatory bodies have identified these technologies as among those which will help progress firm's efforts to meet the transition deadline.

Participants also noted that the “due diligence” issues relating to how progressed their clients were in meeting operational, system and infrastructure initiatives had also not been as aggressive that many would like. Among many participants, including those on track to meet certain milestones and the overall cessation date, the view was that their internal progress was worth nothing if clients were not also on board for the transition. Our corporate and non-bank financial institution participants noted that there was an understood weakness among their own investors or institutional shareholders in meeting the guidelines. There were core explanations that we explore in much greater detail below as to the main challenges clients were facing in meeting the transition deadlines.

WHICH CLIENT OR INVESTOR SEGMENTS DID YOU SEE THE MOST SIGNIFICANT DISRUPTION?



First, there has been a sustained lack of either motivation or resource commitment by a myriad of client types to invest in their transition process. Some of this has increased over the past month post the FCA and ARRC announcements and far fewer challenges from market induced volatility. That has still left a very substantial set of clients—in the retail, corporate, and institutional sectors requiring substantial work. Nearly 40% of end-users reflected that they had only completed high-level planning on communication issues and an additional 40% said they had advanced past planning but only limited outreach to investors or counterparties. European institutions identified somewhat broader progress with their clients due to product certainty and flexibility surrounding SONIA and EUROIBORs vs. the yet resolved issues surrounding SOFR. Resolution of the complex operational, system, contract and product issues all have proven to be an obstacle to further client communication. Most firms had made variant internal progress (relationship manager education, web-site build-out to update clients on industry transition programs) but smaller and mid-size firms still had significant forthcoming. A minority of firms had yet to start a process of linking the risk exposures to their clients, linking them to their documents and considering that overall impact to a firm-wide portfolio of LIBOR exposures requiring an unwind. About three-quarters of the G-SIBs indicated that they had already engaged in some high-level outreach to clients prior to the pandemic; near 50% of foreign banks, while less than 20% of smaller/regional U.S. institutions had started a similar effort. Most of the participants had begun planning those efforts, but the market volatility in specific and the various market lending programs offered as temporary relief to bank clients made a dialogue on LIBOR near impossible. Finally, respondents noted that this was a highly fungible issue — organizations were going to make progress, but the progress would require additional outside resources, investments in technology and a level of product certainty to achieve what was necessary.

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