An Update on the LIBOR Transition and Why It Matters for Wall Street and Main Street

JAKE SIEWERT: This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

In today's episode we're going to revisit LIBOR, or the London Interbank Offered Rate. LIBOR traditionally was used as the base interest rate in mortgages, loans, and much, much more. But over the past couple years there's been an industry-wide transition away from LIBOR. That transition has a big impact both on Wall Street and Main Street in very meaningful ways.

About two years ago we had a podcast on the LIBOR transition. And now we're getting an update on what's changed, the outlook, and the timing, and the like. We're joined once again by Jason Granet, head of the firm's LIBOR transition efforts. Jason, welcome back to the program.

JASON GRANET: It's great to be here. Thanks Jake. Hope you and your family are all well.

JAKE SIEWERT: We are. Thank you. So, Jason, for those who don't follow this issue every day, remind our listeners of why we're going through this transition from LIBOR to a post-LIBOR world and what's at stake here.

JASON GRANET: Sure Jake. Just to take us back a few years, in the summer of 2017 as a result of some work that was done after the last financial crisis, Andrew Bailey, who at the time was the head of the FCA, and now, obviously, leads the Bank of England, gave what is a seminal speech where he came forward and said that the LIBOR panel banks are no longer going to support and produce the LIBOR panel after the end of 2021.

What that did was that set off a chain of events to think through, all right, what is the world going to look like without these rates? What are the alternative rates that can be used? And how is the market going to think through that?

And so, each respective central bank around the world had a working group thinking about these issues. Here in the US the Fed has the ARRC, the Alternative Rates Reference Committee. The Bank of England has their group. The Bank of Japan has their

group. Et cetera. And each one of those groups were tasked with two things: one, coming up with a suggested rate. And two, coming up with best practices and industry framework for smoothly transitioning each of those parts of the market.

And when we last chatted, that was kind of happening in earnest. And all of those rates were just published and rolled out. And those frameworks for a best transition were being brought forward. And that's brought us here today where we've had this acceleration of activity over the last few years. Around that base of a start.

JAKE SIEWERT: Okay, so we were in the early days when we last spoke. But help our listeners get up to speed on what's happened since then? And what's been achieved, what's changed, and where we're headed in the next 450 days till this rate goes away?

JASON GRANET: So, so much has changed yet nothing's changed. The nothing part that's changed is that LIBOR is going to go away at the end of 2021. So, that's the nothing part. But the so much in the fact that there's just been tons of progress across the landscape in actually making that a reality.

You know, when I was here last and we were chatting, there was still some drum beat in the background of "if, if, if." You know, not necessarily "when." Now we're squarely in the when zone. As you indicated, we're inside 450 days. And it's going to be a mad sprint to get there.

The industry had between 40 or 50 consultations. You know, I lost count somewhere around the line. Trying to get all the clarifications and think about what's going on. The derivatives market went through two years specifically of back and forth of consultation and discussions and clarifications to make sure that we get the right industry fallbacks and documentation. And as I talk to you today here in the middle of October, that is all going [UNINTEL] and I'm sure we'll spend some more time on that.

And you know, globally, in all walks of life, in all languages, and all parts of the world there has been engagement on this to get the transition moving. And you know, when I was here last, to put some numbers behind it because at Goldman we love numbers, there were just a few issuance. We were talking about the first Fannie Mae SOFR bond and we could count those first few bonds on our hands. And just last week we're over a trillion in SOFR bonds. And so, it's really been a dramatic move in the

progress in the markets to get here today.

JAKE SIEWERT: You know, obviously the scale and size of the derivatives market is often hard to fathom for people who don't live it every day. So, give us a sense of what's changing in that market. And why is the ISDA protocol, I'll use a little technical language, such a huge deal for the industry at large?

JASON GRANET: So, the beauty from a transition perspective in the derivative worked is that derivatives are just bilateral contracts that you can change as long as the two people on both sides agree to what those changes are. And so, for years and years and years we had a situation where the vanilla version of these contracts referenced LIBOR or some version of LIBOR, all the different derivatives thereof.

And so, now LIBOR is going away, the market had to come to an agreement on the way to deal with changing that. And the reality was, is when these original documentations and contracts and trades were done, there was never really a contemplation of LIBOR going away. And that's why it was this earthquake that we discussed two years ago, "Oh my God, I can't believe," because we're talking about 300 - 400 trillion worth of financial contracts. And then it felt like the rug was being pulled out from underneath.

But as I indicated, over the last two years, better part of the last two years through ISDA's work as an industry organization group and market organization group and owning the standard documentation, they really set out a framework to make it such that all of the aspects of the definitions and the way these things function get recontemplated in a world without LIBOR.

And so, all the protocol is, is a mass way to update all of the see legacy contracts. And so, if I, Jake, had a contract with you, we could get on the phone. We could pull out paragraph out. We could take our pen. We could change it. But when you get to 300 - 400 trillion worth of documents, millions if not trillions of line items, that could be very cumbersome. So we, the industry, have solved that with each entity can just blanket adhere and agree to the new language. And if all of the counterparties that you trade with also blanket adhere, then everyone matches, and you have a situation where all of the trades neatly move on to the new definitions and contemplate life without LIBOR.

And so, it's really a modern miracle for the amount of contracts

that we have to do it and transition in this way. But we, the industry, are taking advantage of the infrastructure to safely move all of these contracts.

And I would just lastly point out that it's really critical that clients really, really focus on adhering and participating in either the protocol or the bilateral amendments that match the protocol, because those legacy documents and trades do not contemplate this event. And at the heart of this is still economics at stake and math and basis points, as we like to say. But if you don't agree to changing your language and updating your documentation, then you're really leaving yourself exposed.

And so we have been very publicly and privately supportive of these transitions. It's been open for the whole world and industry to comment. It's been a global effort. And so, it's just super important that people focus on this. And [UNINTEL] has kind of released all that public documentation here in October.

JAKE SIEWERT: So, it sounds like the industry worked together to create a seamless transition mechanism for these LIBOR contacts, the legacy contracts. How would a high take up rate of the protocol helped mitigate concerns around financial stability?

JASON GRANET: Yeah, so obviously, you know, if we take the converse of that, it folks don't sign up and agree to the new documentation, then we're left with all of these contracts we might not know what to do with. And participants [UNINTEL] would be left with risk they don't know how to manage or can't hedge or can't deal with. And so, instead, high take up would do exactly that. It would be risk management. You would know where you stand economically. You know, all of the members of the global central banks and regulators have all said the only way to get certainty on this from an economic standpoint is to take the pen in your own hand. And you know, we would obviously second and support that.

And so, from a general financial stability perspective, obviously, the more participants in the market that sign and agree to this, the less contracts there will be out there that lack clarity and have to go to some type of resolution through the legal system which, you know, we all want to avoid.

JAKE SIEWERT: So, one of the other big changes put in place after the financial crisis was this emphasis on central

counterparty clearing houses. So, how are some of the upcoming changes to CCPs designed to help the marketplace as well?

JASON GRANET: So, a couple things. One is, this whole process that I'm talking about around derivative contracts, if your counterparty is the central house, then they will automatically adopt all of these new definitions for you. And so, again, you know, the miracles of modern finance allow a lot of risk to be managed and moved in a very smooth fashion.

The other thing is, when you have trades and risk with the central clearing house, there needs to be some type of valuation that's ascribed to that, so people know where they stand. In our technical parlance we talk about mark to markets and these things. But really what it says is I have a trade with the clearing house, what's it worth?

And starting here in the middle of October, the value of those contracts are going to move to the alternative rates, which in the US is the secured overnight financing rate or SOFR. And so, that's going to become the new apples in the system. And when you think about netting it all down, and the movements of risk in the system and the way our clients think about valuations and the way we manage our own balance sheet risk, you need some type of apples to base everything on, which is a common denominator. And that's migrating over to this SOFR rate.

And so by the CCPs changing the apples and the net down rate over to SOFR, that allows it to have grounded and strong liquidity. And folks that actually need to use the rate for real risk management, it allows there to be a real strong foundation in the system to build the rest of the system on top of.

And, you know, one of the things that happened through the years, and you referenced the last financial challenges back in the late aughts, is that you want to have a strong foundation on whatever you build your risk and system on. And so, by taking the SOFR rate and making it the strong foundation, that should definitely help the system going forward.

You know, as we discussed two years ago, the SOFR rate is the rate that is published by the Fed. It's owned by the Fed. They publish it on their website each day. It's got a trillion plus in volume. And so it's a really substantial, well-grounded rate. I like to say, "All weather, all clad," that the system can be built on top of in a very safe way.

JAKE SIEWERT: So, obviously LIBOR and the transition of SOFR and other reference rates is a huge deal for the derivatives market. How about some of the other big global markets? Let's say lending, bonds, et cetera, how are those playing out so far in this transitional period?

JASON GRANET: How are they playing out SOFR?

JAKE SIEWERT: Pun intended.

JASON GRANET: Yeah. The pun completely intended. So, here's what I would say about the other markets. The challenges in the other markets exist because the amendments and the ability to change documentation is really, really, really challenging. And we talked about how easy it is in derivatives, whether it be at the central houses or through these industry-wide documentation signing processes.

When you have a bond or a loan or all of these other markets, it's really hand to hand combat, one line item by one line item. You know? A widget company has an outstanding bond that references LIBOR, they need to go and deal with that CUSIP and that bond and that specific line item. And they have another one, they have to deal with that one separately. And so, it becomes a lot more challenge and difficult. You can seek consent and votes from shareholders. You can do all types of things. But again, operationally cumbersome and hugely difficult.

One thing that the industry and the market is very focused on is the possibility of a legislative solution. There have been proposals that have been circulated and drafted for New York State for contracts in New York. There have been early discussions of things possibly at the federal level. The UK has put forward some things in front of Parliament. The European Commission has put things forward in Europe to do as well. And I would say what the industry and the market is focused on kind of broadly globally is two things. Number one, stop producing new of this stuff because they're difficult to deal with. And number two, see if there's a possible legislative avenue to tell with the ones that are difficult that the industry has deemed the, quote, "tough legacy." Now, there are some of those bonds and loans and things that have been issued more recently that do have good fall back language. The industry groups and the system and organizations like ours have helped our clients use better language in more recent, vintage markets. But if you go back before 2017, before this was a thing, it never really contemplated it. And the ease that exists in the derivatives

markets doesn't ease here. So, there's going to have to be some broad-base solution and we're working on those things as I indicated with possible legal avenues.

JAKE SIEWERT: So Jason, you've been at this for a long time. And you've referenced earlier that you've been in regular contact with our clients and sort of urging them to focus on this transition. What are clients thinking about this? I know it's hard to generalize, but what are the typical reactions you're getting from clients? And what are they doing to prepare?

JASON GRANET: Yeah, so the last time we chatted clients were like, "Huh? What? You know, I read about that," maybe. And they were very appreciative that we were bringing this in front of them. And now clients are sending us action plans and they're starting to really change things. You know, I had an email exchange with a client today who has a full, comprehensive plan across their corporation on how to think about this in all the different places.

And so, you know, where the guidance before was more around, take inventory, think about where your exposures are, do those types of things. You know, that's definitely the case if you haven't done it. But we definitely have moved into the more action portion of the program. You know? A lot of our clients, whether it be corporations, investment managers, otherwise, they all have their toes in some way dipped into the derivatives market. So they're going to think about redocumenting over the course of this fall and winter as was referenced before.

The lending markets are highly connected to that as people think about the way derivatives interact with their loans to make sure that their risk management is handled properly. And so the knock-on effects there are going to happen.

And then I would point some people to some non-traditional places. You know, we've talked to our corporate clients about their 401(k) plan offerings. We've talked to clients about their procurement contracts or someone who's engaged in a real estate project or their real estate space. These lending rates, these LIBOR rates show up in all kinds of places. The more you peel back the onion, the more you find them in different places. And so, it's a situation where we're now into the action portion of the program where there's really action that has to be taken to migrate and safely get there. We're just over a year. And you know, it's a critical time. And some of these things require meaningful technology uplift or working with your tax advisors

or accountants and others. And so, getting all of those things lined up as we've learned here at the firm can take a little time in the industry. And so, you know, it's really, really a recommendation out there to start digging in and thinking about the action that needs to be taken, not just surveying the property for your exposure.

JAKE SIEWERT: Okay, so Jason, you've been a pioneer in this space. What are some of the best practices you can share with our listeners?

JASON GRANET: The first thing is, what we like to say is, take it head on. You know? This is out there. It's happening. Over this year, which has been one of the more unique years that will impact all of our lives in so many ways, the focus on this has not waivered at all, whether it be from the financial sectors, official sector, there are regulators, et cetera, they've increased the cadence by which [UNINTEL] are acting, the industry working groups, you know, we've all met with much more frequently. And so, I just really encourage to be transparent, communicative, and take it head on. The more that we can have an open dialogue with our clients, the more we can have an open dialogue with end users, the more we can uncover where the real difficult challenges are. And then, you know, what's been really nice about this is it's been a lovely partnership between the public and private sector. The public sector has been very responsive. We just got some IRS clarifications and other clarifications from the CFTC and some other places. And it's been a real great-- showing the best of our society and pulling these things together to get a smooth transition.

And the only way we can do that is if we surface the issues. And so, my real big best practice advice is be transparent, be communicative, be proactive, raise things. And you know, I feel comfortable that the right people are spending time to get us to the other side in a risk-free way. And we'll work through it and get those things over.

JAKE SIEWERT: All right Jason. Good advice. Thank you once again for joining us today.

JASON GRANET: It's a pleasure, Jake. Thanks so much.

JAKE SIEWERT: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed the show, we hope you subscribe at Apple Podcast and leave a rating or a comment. And please tune in later in the week for our

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