LIBOR TRANSITION

The generally quoted LIBOR transition date of December 2021 is now less than a year away. Almost every conference has a session on the topic and at Actualize we see a marked increase in the request for information and advice from our clients. In this overview we explain the issue at hand, why there is a meaningful financial impact looming, and an outline for how to get practically started with an all-encompassing transition plan.

Wait, with everything else going on right now this is still happening?

In a word, "Yes." But the more specific question of when is a little trickier to answer. Further updates towards the end of 2020 are worth noting and show that across the major currencies there is increasing divergence on the transition date.

Around Easter of 2020, a statement from the UK FCA and Bank of England confirmed the following:

"The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet."

On November 30, 2020, ICE announced that 1-week and 2-month USD LIBOR will cease to be published after December 30, 2021, but that the major USD LIBOR settings (1, 3, 6 & 12 Month) will continue to be published until June 30, 2023.

On December 9, 2020, the EU extended the transition period for when EU supervised entities could continue to use the benchmarks until December 31, 2023.

What does this mean to my company?

Simply put, any existing or new contract that requires a LIBOR fixing in 2022 and beyond will be impacted. For most treasuries, this impacts internal and external borrowing rates directly. Any interest rate or cross-currency hedging swaps are affected, and indirectly even the valuation of longer-dated FX derivatives will be impacted. Collateral requirements will also be impacted by a switch away from LIBOR.

So, LIBOR is just gone. Is there is no fallback in place?

Fallback. Clever, I see what you did there.

The ISDA 2020 IBOR Fallbacks Supplement and Protocol published in late 2020 and effective in January 2021 were designed to address how derivatives will fall back to replacement rates in the event of cessation of a rate such as IBOR. Practically, these fallbacks will represent the required risk-free rates (RFRs) per jurisdiction. Some of these RFRs are well known and established with pricing in some cases dating back to the 1990's (Japan) although most have been active only in the last 5 years or so.

Currency	RFR	Description
AUD	AONIA	Reserve Bank of Australia Interbank Overnight Cash Rate
CAD	CORRA	Canadian Overnight Repo Rate Average
CHF	SARON	Swiss Average Rate Overnight
EUR	€STR	Euro Short-term Rate
GBP	SONIA	Sterling Overnight Index Average
HKD	HONIA	Hong Kong Dollar Overnight Index Average
JPY	TONIA	Tokyo Overnight Average Rate
USD	SOFR	Secured Overnight Financing Rate

Ah, so this is all pretty straightforward then – just Find/Replace LIBOR with RFR?

If only it was so simple.

No. Quantitatively, from a valuation point of view, RFRs don't calculate in the same way as LIBOR does, so they are not a straight replacement. For instance, the RFRs are compounding rates and are set in arrears. LIBOR Rates are set in advance. And given the whole point of this is to move away from a "risky" LIBOR rate to a true risk-free rate, one should expect some valuation impact to the existing and ongoing portfolio of interest rate exposure a company has.

One point to be cognizant of is there are competing RFR in some currencies, so unlike LIBOR there may not be one consistent approach going forwards. It is a little earlier to conclude on the final outcome but we intend to publish further updates specifically on RFRs throughout 2021 as market adoption evolves.

After much review, the agreed industry approach is as follows:

The RFRs (which are typically daily) will be compounded over the relevant LIBOR period (for example, 3M in the standard case for USD) and a spread adjustment will be added to the compounded rate. Further, the spread adjustment will be based on the median over a 5-year period based on the historical differences between the relevant LIBOR and RFR rates. In our example, the difference between 3M LIBOR and SOFR. Given these rates are published, the spreads can be calculated independently or sourced directly from market data providers.

In the case of LIBOR, a full-term structure of rates was published. Market participants would take slightly different approaches to constructing a curve, for instance whether the 2-year observable is best represented by a Eurodollar future of the appropriate maturity versus a 2-year LIBOR swap rate. In the post-LIBOR world, a full-term structure is not currently available. Pardon the pun, but some currencies (notably USD) are more mature than others in the availability of RFRs with longer than a day maturity. Until this is resolved, market participants are reliant on mathematical approaches to calculate an implied 2-year rate (to continue the point).

Quantitatively, the spread calculated a couple of months ago calculates in the order of 1.5%, which implies a meaningful impact to the MTM of the positions themselves as well as the knock-on impact to posting collateral and hedging requirements.

LIBOR 3M USD and SOFR comparison table

Date	LIBOR 3M	SOFR
30-Jun-19	2.320	2.272
31-Jan-19	2.738	2.443
30-Jun-18	2.336	1.936
31-Jan-18	1.778	1.541
30-Jun-17	1.299	1.048
31-Jan-17	1.035	0.655
30-Jun-16	0.654	0.403
31-Jan-16	0.613	0.365
30-Jun-15	0.283	0.142
31-Jan-15	0.253	0.101
30-Jun-14	0.231	0.058

So that's the numbers part. What about the contracts?

By their nature, loan and OTC derivative contracts involve two parties, and an agreement must be made as to how the existing contracts should work. For contracts bound by ISDA, the amendments defined in the IBOR Fallbacks Supplement and Protocol offer an alternative to implement fallback language, but must be agreed to by both parties to the transaction. All new derivative contracts will incorporate these fallbacks (and thus counterparties will not have to take any additional steps). For existing deals, it is expected that parties will work to mutually agree to amend their non-cleared contracts. For cleared derivatives, clearinghouses are expected to update their terms of conditions to unilaterally implement the fallbacks into all legacy cleared transactions.

OK, so I can sense there is no "do nothing" option here. But how do I get started?

As with all major change projects, a good place to start is with an impact analysis; begin with data gathering of your own IBOR inventory:

TOPIC	DETAIL	OUTCOME
IBOR Inventory	Create a matrix of all existing deals by: • Contract type • Product • Currency • Counterparty (Int or Ext)	Each cell represents a potentially different impact

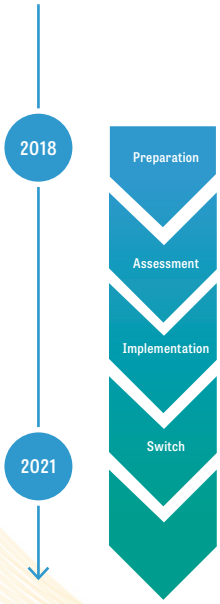
It should be clear that the impact of this change will touch a number of departments within a company, from legal, financial risk, accounting to systems. As such, the next step would be a front to back impact analysis.

TOPIC	DETAIL	OUTCOME
Legal	Contract Review	Agree on response by contract type
Systems	Review systems capability of RFR support	Potential outcomes ranging from: Fully complies in current system TO No current capabilities exist or planned by end 2021
Finance	Assess accounting/tax changes	Requirements to relevant processes/systems
Group Impact	Review of intercompany loans	Agree changes to borrowing terms
Risk Mgmt	Assessment of financial risks	Quantify financial impact and define mitigation approach
Internal Audit	Review of new products	Requirements for model validation

Action!

Impact analysis feeds naturally into an overall transition plan. A cross workstream program is recommended with Program Delivery and Governance collating all of these related but separate activities. An agreed cutover date for all streams must be co-ordinated. Prior to that, workstreams can move independently as appropriate. It is important to allow sufficient time for the external deliverables (for instance, any systems development, legal negotiations, etc.).

Transition program overview



PROGRAM DELIVERY AND GOVERNANCE	FINANCIAL RISK MGMT	LEGAL	CUSTOMER COMMS	PRODUCT	SYSTEMS	OPERATIONS	FINANCE
Establish Program			Draft comms plan				
Define, plan, identify risk	Assess current exposures	Contract review		Determine set of required new products	Determine internal and external system changes	Assess impact to controls and processes	Determine accounting tax changes
Training execution	Agree on risk strategy	Start negotiations	Customer/ Bank engagement	Agree on updated product portfolio	System build, test	Review & update policies and procedures	Design & implement solution
Co-ordinate rollout	Quantify impact and switch	Contracts amended	Execute all comms	Confirm rollout	Roll out	Update controls framework	Roll out
Shut down Program			Final comms note	Discontinue existing products			

There really is no time to wait.

Actualize is a boutique consultancy and our team is made up of experts from treasury practitioners, subject matter experts, software specialists, and integration architects. We specialize in applying real solutions to problems. We would love to speak with any client to help guide them through this journey.