

LIBOR TRANSITION

The LIBOR transition date of June 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." Around Easter of this year a statement from the UK FCA and Bank of England confirmed as follows:

"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."

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 affected. 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.

Specific fallback rates to replace LIBOR are set out in the 2006 ISDA Definitions. ISDA is working on new robust fallbacks that would apply in the event of a permanent cessation of a key interbank offered rate (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?

Would that it were 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.

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.

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, amendments are underway to the 2006 ISDA definitions to implement fallback language. Once the supplement is published, 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 LIBOR inventory:

| TOPIC | DETAIL | OUTCOME |
|-----------------|---|---|
| LIBOR Inventory | Create a matrix of all existing deals by: <ul style="list-style-type: none"> Contract type Product Currency Counterparty (Int or Ext) | Each cell represents a potentially different impact |

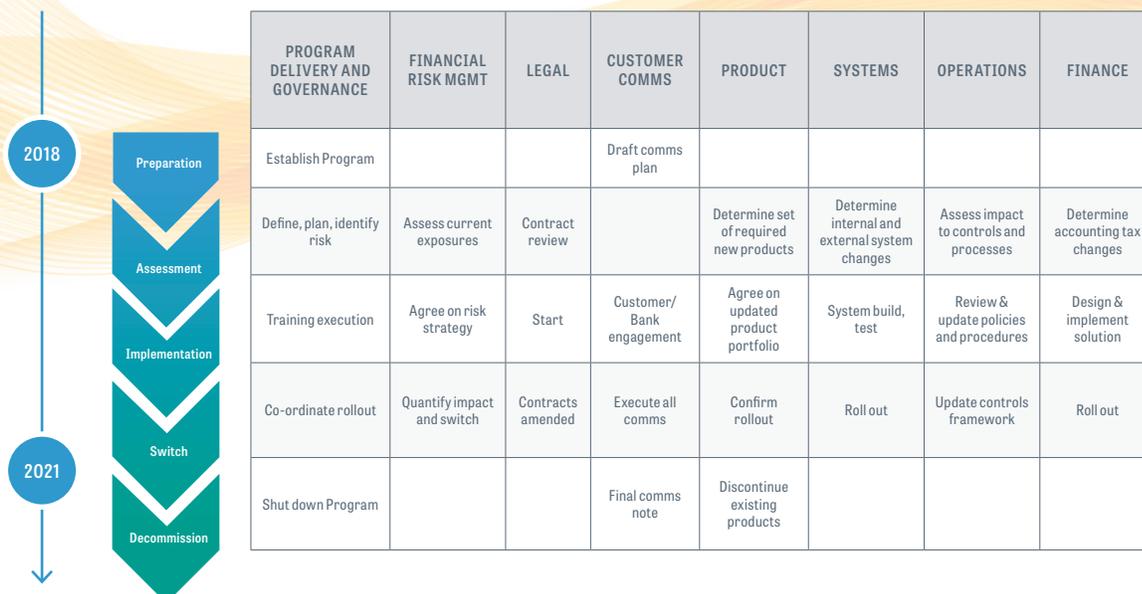
It should be clear that the impact of this change will touch a number of departments within a company, from legal, financial risk, accounting to systems. As such, the next step would be a front to back impact analysis.

| 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



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.