Evolving environment

LIBOR transition amidst Covid-19 driven detour and the way forward

It is said that all good things come to an end – a notion that the legacy proponents of LIBOR would endorse about this benchmark that has underpinned billions of dollars worth of financial products and trades annually over the last four decades. Until recently it was estimated that at least USD 350 trillion in derivatives and other financial products are tied to LIBOR – a number that has gradually declined ever since the LIBOR scandal of 2008-12 period. The scandal led to LIBOR reforms followed by UK's Financial Conduct Authority's decision in 2017 to no longer compel panel banks from making LIBOR submissions after FY 2021.

Initial reporting relief

Since that time it has become evident that global regulators' preferred LIBOR replacement is a risk-free benchmark rate that is based on actual transactional data. Consequently, the corresponding regulatory and corporate space has been rife with activity in this regard with a focus on matters such as determination of term-rates, assessment of fallback provisions, and system and process changes to tacking financial reporting challenges. To facilitate the transition, a phased project by the International Accounting Standard Board and concluded in August 2020, has granted various financial reporting exemptions in the wake of transitional uncertainty providing much needed relief to reporting entities across the globe. The exemptions enable entities to insulate their books from the exclusive impacts of transition on affected financial instruments and hedge relationships.

Moreover, in July 2020, Bloomberg began calculating and publishing fallback rates to be used to calculate the adjusted risk-free rates (RFRs) for IBOR derivative fallback, whereby entities can begin to use this data to test their system readiness for the derivative fallbacks. In October 2020, the International Swaps and Derivatives Association (ISDA) launched the IBOR Fallbacks Supplement to the 2006 ISDA Definitions and the ISDA 2020 IBOR Fallbacks Protocol, to take effect from 25 January 2021. This was warmly welcomed by the Financial Stability Board, UK Regulators and Working Group and the US Alternative Reference Rates Committee (ARRC), encouraging prompt adherence to the protocol to assist the transition of derivatives away from LIBOR and help avoid disruption to derivative contracts held by financial and non-financial firms when LIBOR ceases or is considered unrepresentative. Another key development during the second part of 2020 was the switch from the Effective Federal Fund Rate (EFFR) to Secured Overnight Financing Rate (SOFR) by clearing houses, like the Chicago Mercantile Exchange (CME) and the London Clearing House (LCH) for all outstanding cleared USD-denominated swap products.

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The switch is expected to encourage the build-up of liquidity in SOFR products.

Covid-19 impact

However, amidst the economic and operational turmoil caused by Covid-19, apprehensions began to grow that the transition from LIBOR to Alternative Reference Rates by the end of 2021 may prove to be more challenging than initially anticipated. Consequently, in November 2020, LIBOR's administrator, the ICE Benchmark Administration (IBA), made an announcement signaling that while almost all non-USD Libor maturities would cease to be published post December 2021, the publication is expected to continue for most USD LIBOR liquid maturities until June 2023.

Subsequently, the Finance Conduct Authority (FCA) in UK announced that there would be a case for using the proposed new powers to ensure an orderly wind down of LIBOR. This transition includes the continued publication of some critical benchmarks via a change in methodology to produce a "synthetic LIBOR" that is based on a forward looking risk free rate, already chosen by the national working group for the relevant currency, plus a credit spread.

USD LIBOR

Across the Pacific, the US authorities highlighted that the envisaged extension in the timelines for the transition of various USD LIBOR maturities would result in most legacy USD contracts maturing before the cessation of USD LIBOR. Notwithstanding, the authorities have placed an emphasis for entities to discontinue issuing USD LIBOR contracts, by December 2021 to facilitate the eventual transition.

The foregoing changes require careful assessment for entities affected by the LIBOR transition and their related plans. It is essential to remember that the timelines for cessation of non-USD LIBOR have not changed while at the same time corporates may take comfort in the notion of synthetic LIBOR for those GBP LIBOR referencing products that are extremely difficult, or even impossible, to transition. On the other hand, entities have been granted a 'breather' vis-à-vis USD LIBOR products to ensure an orderly transition of legacy assets and trades. Nonetheless, despite the change in timelines, the developments of past year have all but cemented an imminent future without LIBOR and therefore, for entities around the globe, the key to successfully manage the transition process lies in proactively transitioning away from legacy rates with continued focus on operational, process and systemic changes to address the phased cessation events.

Farid Memon
Director, Assurance and DPP
KPMG in Saudi Arabia

Farid Memon has 16 years of experience with the KPMG network, providing assurance and accounting advisory services to banks and other financial services clients. Through his membership of the Department of Professional Practices (DPP), he has specialized in resolving complex financial reporting and accounting issues