Evolving LIBOR
Managing the transition to new Risk Free Rates

LIBOR - what is changing?

Interbank offer rates (‘IBORs’) are systemically important benchmarks underpinning many contracts within the financial sector globally. There are estimated to be over $370tn contracts currently referencing them from US retail mortgages to derivative contracts and corporate loans.

Following the OSSG recommendations in 2014 to move the industry towards new risk free interest rate reference rates (‘RFR’s’) the industry has been developing proposed new reference rates. In 2017 the FCA’s confirmed that it will no longer compel banks to submit data to LIBOR post 2021 resulting in a clear impetus and need to implement these alternative RFR benchmarks globally.

To date US, UK, Swiss and Japanese Working Groups (‘WG’) have developed SOFR, reformed SONIA, SARON and TONA. The EU WG is yet to finalise its RFR.

The RFR’s have been designed to be based on transactions (where practical) with minimised reliance on expert judgement and are based on overnight rates.

What are the key challenges?

- **Significant scale to the transition**
  - Impacts all clients participating in IBOR related contracts
  - US/UK/Euro likely to have different timelines
  - Detailed transition timeline needed

- **Operational & Conduct risk**
  - Introduces conduct risks with the changes in benchmark and spreads applied
  - Large scale changes in legal documentation, models and curves introduces significant operational risk

- **Hedge accounting impact**
  - Expected to impact forecast transactions
  - Hedge effectiveness tests need to changed in accounting standards

- **Identifying all products impacted**
  - All existing & new contracts
  - Derivatives, loans, bonds, and mortgages
  - Key terms may not be easy to identify e.g. fallback mechanisms

- **Developing wider liquidity in new underlying market**
  - Liquidity needed in new SOFR/SONIA based products
  - Momentum needed to drive the transition across the market

- **Changing the basis**
  - No term structure as RFR overnight rates
  - The legal mechanism for fall-backs being designed
  - The credit spread mechanism at transition to be agreed

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What do firms need to do?

Firms need to assess the impact of the transition across their products, clients and infrastructure. The impact on products will need to be considered from front to back across an organisation covering key functions: Sales & Trading, Operations, Risk & Valuations, Treasury, Legal, and Compliance.

The differences in approach and timing across the US, UK and Europe will require a well-coordinated programme of activities to ensure changes are joined up.

**RFR Governance & Oversight**
- Project management/governance control of all workstreams ensuring delivery of RFR transformation programme
- Wider impact assessment across the organisation ➔ prioritisation
- Managing diverse timelines (Geography/Asset/Product Class)
- Manage external stakeholders e.g. regulators/customers

**Business & Front Office**
- Collateralisation - management
- PAI
- Settlement/cash flow
- Confirmations

**Operations**
- Regulatory tracking and impact
- Different regulatory requirements/treatment of RFRs across jurisdictions

**Legal**
- Valuation impacts (e.g. term structure curves/market value/secured vs unsecured)
- Risk management (hedging)
- Models' review & market risk sensitivities
- Price testing
- Assurance & QA of risk systems

**Compliance**
- Technology enhancements
- Infrastructure impact mapping
- Adjusting relevant support systems e.g. trade capture, payment systems & inter-company funding arrangements

**Treasury**
- ALM Internal funding
- Changes to issuance and hedging programmes
- Transfer pricing implications

**Valuations & Market Risk**
- Identify business lines in scope
- Position/product inventory
- Economic sensitivities
- New curve construction & risk management change
- Client outreach and communications

**Accounting, Finance & Tax**
- Identification of all contracts
- Renegotiating/rewriting legacy contracts
- Fall-back provisions
- Legal consent & legal/statutory obligations
- Standard documentation (e.g. ISDA and FIA)

**IT & Infrastructure**
- Hedge accounting/effectiveness
- Forecast transactions
- Modification accounting
- Impact on discounting
- Differences in tax treatment/payments due
Developing a clear timeline?

There is a clear impetus to make the change up to 2021. Timelines are being developed, but there are going to be variations across jurisdictions.

### RFR timelines

**2018 - 2019**
- **Planning & industry engagement**
  - 23 April '18: Reformed SONIA publication begins
  - 3 April '18: SOFR publication begins
  - 29 March '19: BREXIT Article 50 cut-off
  - TBC: LIBOR authorised EU BMR benchmark
  - TBC: EURIBOR defined as EU regulated benchmark
  - TBC: EONIA EU BMR status to be confirmed

**2019 – 2020**
- **Implementation & preparation**
  - TBC: EURIBOR defined as EU regulated benchmark
  - December '19: New ECB overnight rate published
  - TBC: EURIBOR defined as EU regulated benchmark
  - 1 January '20: EU BMR transition period ends

**2021 onwards**
- **Product transition & readiness**
  - TBC: EURIBOR defined as EU regulated benchmark
  - Early 2021: RFR products maturing
  - End '21: LIBOR submission compulsion ceases

### Outstanding industry building blocks

- **Clear & detailed industry timeline**
  - A clear timeline and approach has not been defined for an industry transition. Need to bring in all regions, products and industry in line (big bang).

- **Regional approaches**
  - There are clear differences by RFR region – US, UK, Europe, Japan, Switzerland taking slightly different approaches and are at slightly different stages of implementation.

- **Liquidity**
  - Organisations need to maintain and implement liquidity to use new RFRs e.g. industry created RFR products need hedging.

- **Education**
  - Bring wider market participants, industry and end clients up to speed.

- **Technical issues (fallback, tenor & credit spread)**
  - The new RFR’s are overnight indices and currently have no term structure unlike IBOR’s. Whilst term structures potentially rebuild for new products, a mechanism is needed to ease back book adoption.

- **Market infrastructure**
  - The exchanges and clearing houses are starting to build out RFR products and services in certain jurisdictions.
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