Moving with the change

Planning and preparing a move toward alternative reference rates

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Zurich

Market reform around benchmark rates has been in the works since the Wheatley Review[1] was released in 2012. Since then, reforms have been advanced through observations and principles in two main reports: the International Organization of Securities Commission's (IOSCO) *Principles of Financial Benchmarks*[2] and the Financial Stability Board's (FSB) *Reforming Major Interest Rate Benchmarks.*[3] Each of these reports sought to strengthen rather than replace existing benchmark rates, such as the London Interbank Offered Rate (LIBOR), and consequently has not resulted in upheaval in markets or panic by market participants.

However, in July 2017, the Financial Conduct Authority (FCA), announced that it will not compel or persuade panel banks to make LIBOR submissions after the end of 2021. This declaration has unleashed a maelstrom of activity around not only choosing alternative reference rates but also developing the roadmap needed for transitioning from LIBOR to those new rates. Given that the permanent discontinuation of LIBOR seems likely, firms that have contracts referencing LIBOR must begin planning and preparing to ensure the transition away has minimal financial and operational impact.

Key points

1

Reliance on LIBOR is unsustainable

This precipitous decline in unsecured wholesale borrowing activity underlying LIBOR rate setting and increasing reliance on expert judgement has raised concern about the long-term sustainability of the LIBOR benchmarks as well as their vulnerability to manipulation. The availability of LIBOR beyond 2021 is highly uncertain and the scale of the market suggests that there would be significant market disruption and confusion should publication cease without action.

2

The industry must act collectively and purposefully

The pace at which the financial services industry, working groups, and financial regulators can create markets for new and alternative reference rates, build liquidity and term structure, and list and clear new products will directly impact the success of the transition.

3

Individual firms must first assess their fallback options

Independent of industry preparations, individual firms must assess the potential impact to their products, infrastructures, and customers that a transition away from LIBOR would evoke, and develop a transition plan, beginning with identifying all LIBOR contracts and assessing the related fallback options.

A time for change

LIBOR is used as a reference rate, or benchmark, of the average rate at which banks are able to borrow from one another in the short-term money markets. It is calculated daily based on rates quoted by a panel of banks for five currencies (U.S. dollar (USD), Pound sterling (GBP), Japanese yen (JPY), Swiss franc (CHF), and Euro (EUR)) across seven maturities (overnight, one week, and 1,2,3,6, and 12 months). LIBOR is one of a number of interbank offered rates (IBORs) currently in use.

The combined gross notional exposure of contracts referenced to these interbank offered rates was estimated at more than $370 trillion as of 2012[4]. At the end of 2016, the estimated total exposure to USD LIBOR alone was nearly $200 trillion[5] spanning a broad range of market participants in a variety of products, including:

— Market participants: Central counterparties (CCPs), exchanges, investment banks, retail banks, insurance/reinsurance companies, broker-dealers, hedge funds, pension funds, asset managers, and corporations

— Products: over-the-counter derivatives, exchange traded derivatives, corporate bonds, business loans (syndicated and non-syndicated), floating rate notes, consumer loans (such as mortgages and credit cards), and securitizations.

Despite the size of the market and the use of LIBOR by market participants over numerous products, the FCA, which is responsible for regulating LIBOR, highlighted that, other than overnight transactions, there are relatively few unsecured wholesale term borrowing transactions on which the reporting panel banks can formulate the quoted rates. This absence of active underlying markets and increasing reliance on expert judgement has raised concern about the long-term sustainability of the LIBOR benchmarks as well as their vulnerability to manipulation. Further, it runs counter to the recommendations of the FSB to strengthen benchmark rates, including LIBOR and other potential reference rates, by underpinning them to transactional data.

Concurrent with its recommendations to strengthen benchmarks rates, the FSB also recommended developing alternative, nearly risk-free reference rates (RFRs). To that end, five currency Working Groups, representing the U.S. dollar, Pound sterling, Japanese yen, Swiss franc, and Euro, were formed to consider, recommend, and promote alternative RFRs within their home jurisdictions. RFRs have been recommended for four of the five currency groups and the fifth (i.e., Euro LIBOR) has only recently been selected. These alternative RFRs are being developed as primarily transactions-based and tied to overnight borrowing rates.

Currency	Working Group	Alternative RFR	Publication date
USD	Alternative Reference Rates Committee (ARRC)	Secured Overnight Financing Rate (SOFR)	April 2018
GBR	Working Group on Sterling Risk-Free Reference Rates	Reformed Sterling Overnight Index Average (SONIA)	April 2018
JPY	Study Group on Risk-Free Reference Rates	Tokyo Overnight Average Rate (TONAR)	December 2016
CHF	National Working Group on CHF Reference Rates	Swiss Average Rate Overnight (SARON)	August 2009
EUR	Working Group on Risk-Free Reference Rates for the Euro Area	Euro Short-Term Rate (ESTER)	Projected prior to 2020

The reforms to interest rate benchmarks will have a big impact across financial markets, from Wall Street to Main Street. Making sure the entire market appreciates the scale of the issue and takes early action is therefore a priority.

"Given the scale of the task, this is not something that can be resolved in the months before end-2021. To ensure a successful and orderly transition, institutions need to be taking action – and starting now.

Scott O'Malia,
ISDA Chief Executive Officer,
July 4, 2018

Tokyo

Re-routing reform: collective industry action

Establishing viable alternative RFRs to stand in for LIBOR will require Working Group members, key end-users, and other market participants to help create markets for new instruments underpinned by the new RFRs. Together they must help to build a critical mass of liquidity and ultimately form a viable maturity curve for each of the new rates. CCPs and exchanges will be expected to facilitate these efforts by listing and clearing the RFR-referenced products. The pace at which this can be accomplished will impact the success of the adoption timelines.

Key actions

Any change that impacts a market the size, scale, and breadth of the LIBOR market is bound to be wrought with challenges. Key challenges include:

— Achieving agreement between regulators, market participants, and other interested parties as to the best alternative successor/ fallback rate

— Facilitating broad market acceptance and adoption of the new benchmark rates

— Developing liquidity in new products underpinned by new RFRs and facilitating the build toward term structures in the new RFRs

— Determining transition mechanics – migrating unsecured rates to secured (risk free) rates minimizing the value transfer risk upon transition

— Determining the triggering event to establish permanent discontinuation of LIBOR

— Communicating changes and protocols to a wide and diverse marketplace.

ISDA Initiative

The International Swaps and Derivatives Association (ISDA) has been working on an initiative to implement fallback language should LIBOR be permanently discontinued. Among the efforts ISDA has undertaken include market wide consultation to establish a set of objective triggers to signal a permanent discontinuation of LIBOR. It is expected that when the triggers are finalized the 2006 ISDA Definitions will be amended affecting all new and subsequent transactions. Moreover, ISDA has signaled it plans to publish a protocol addressing fall back language for existing derivative contracts. ISDA has also established several industry working groups to address a number of technical issues including the basis spread methodologies and term fixing adjustments.

Accounting considerations

Accounting-related issues could be triggered for certain assets (e.g., loans and securities) and liabilities (e.g., debt, retail credit agreements, and mortgages) indexed to LIBOR upon transition to a new benchmark reference rate. These issues might include: de-designation of existing hedging relationships and associated income statement volatility; re-evaluation of off-balance sheet treatment for certain legacy securitization transactions; and changes in fair values and cash flows calculated using discounted cash flow models and the related financial statement impacts. The breadth of the accounting impacts is not fully clear and is being further explored by accounting standards setters and market participants. In the U.S., the Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update (ASU) in response to the ARRC's selection of SOFR as an alternative RFR to LIBOR. As proposed, the list of U.S. benchmark interest rates permitted in the application of hedge accounting would be expanded to include the Overnight Index Swap (OIS) rate based on SOFR.

“The absence of ways to remedy the current underlying weakness in LIBOR – the lack of transactions, the unattractive prospect of LIBOR limping on with fewer panel banks, and the significant problems associated with a synthetic LIBOR, all lead to the same conclusion. The best option is actively to transition to alternative benchmarks. The most effective way to avoid LIBOR-related risk is not to write LIBOR-referencing business.”

Andrew Bailey,
Chief Executive,
Financial Conduct Authority,
July 12, 2018

New York

Re-routing reform: firm-specific action

A phase-out of LIBOR will have far-reaching implications for any institution or entity that is party to LIBOR-linked financial contracts or agreements. Individual firms must understand the scope of these implications and define a strategy to transition toward a new regime. They must assess the impact of such a transition on their products, customers, and infrastructure, taking a front-to-back perspective across key functions including sales and trading, operations, risk, valuations, treasury, legal, and compliance. All of this must be accomplished in an environment marked by a high degree of uncertainty and unanswered questions. Even so, it is possible for firms to move forward by building in flexibilities to accommodate the transition to RFRs as they become established. Firms that engage in planning at the earliest possible opportunity will secure crucial advantage in making the transition both effective and efficient.

Brussels

Key actions

Firms should actively begin to structure their transition plan by establishing a project management office that will oversee risk assessment, risk mitigation, transition design, and implementation. The process to fully transition from IBORs to RFRs will span several years and consume significant resources. Given the present level of uncertainty, it may be prudent to focus attention on key priorities initially while developing a plan or roadmap for permanent discontinuation. The initial efforts should focus on:

- Establishing an **enterprise-wide governance structure** to oversee communications, program management, and planning across the business lines and supporting functions
  - Convene a steering committee, including enterprise, legal, accounting, and operations
  - Define internal communications plan; Participate in industry advocacy
  - Determine project scope, including business, products, and systems
  - Undertake enterprise-wide capabilities assessment
  - Establish governance, workflows, monitoring, and reporting requirements
  - Develop transition scenarios, assign probabilities and potential budgets
- Identifying **contracts** with reference to LIBOR and analyzing **legal language**
  - Identify and inventory all LIBOR-referenced contracts
  - Identify and assess the fallback language in each contract
  - Develop more robust fallback-specific amendments
  - Implement a process to replace existing language with new amended language
- Developing a **strategic plan** based on economic impacts to the existing book of business and the potential business opportunities arising from use of new RFRs
  - Establish client communication and negotiation workflows
  - Review contract structure and simulate alternative RFRs
  - Evaluate profitability, cashflow, and hedging risks
- Creating an **inventory of systems**, infrastructure and functions that will require changes
  - Identify current contracting processes using legacy fallback language
  - Update operating model, including automated processes, to reflect new fallback language
  - Determine process to onboard and implement new rates and contracts
  - Assess potential for conduct risks arising from changes to reference rates

Improving the chance of a timely transition

Given the sheer size of the market and the number of outstanding contracts underpinning the marketplace, most if not all firms will find the task to transition daunting. Firms have quickly recognized the need to incorporate cognitive techniques such as Natural Language Processing and Machine Learning to help. Finding LIBOR contracts across multiple systems and businesses will require cognitive techniques to expedite the process.

Unfortunately, the cognitive solution doesn't work if the LIBOR contracts are tucked away in a file cabinet. Finding and ingesting LIBOR contracts is only the tip of the iceberg, firms will need to "teach" machines to not only identify relevant contract references, but how those references may permeate in different forms throughout the financial contract.

While Cognitive Techniques will help expedite the initial analysis and effort it will not solve everything. Convincing clients that the additional basis point add-on is fair and equitable is going to take a well thought out commutations program and maybe some personal interaction.

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Firms that engage with planning at the earliest possible opportunity will secure crucial advantage in making the transition both effective and efficient. Although the outlook for LIBOR is uncertain, it is possible for firms to move forward with careful scenario planning, building in flexibilities to accommodate the transition to RFRs as they become established. Along the way, it is critical that firms place end users and customers at the forefront of their planning, in parallel with the complexities of technical implementation.

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[1] *The Wheatley Review of LIBOR:* final report, September 2012. Independent report, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf

[2] The Board of the International Organization of Securities Commissions, *Principles for Financial Benchmarks: Final Report,* July 2013. Available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf. These principles include 19 specific standards across governance, benchmark quality, methodology, and accountability.

[3] The Financial Stability Board, *Reforming Major Interest Rate Benchmarks,* July 2014. Available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf. Also see progress reports.

[4] The Financial Stability Board, *Market Participants Group on Reforming Interest Rate Benchmarks: Final Report,* July 2014. Available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf

[5] *Second Report, Alternative Reference Rate Committee,* March 2018. Available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report

> **…firms who are not yet aware, not yet engaged, and without plans to address their LIBOR-related dependencies, I warn you again of the risks.**

Andrew Bailey,
Chief Executive,
Financial Conduct Authority,
July 12, 2018.

Contact us

Christopher Dias
Principal
Financial Services Advisory
T: 862-703-8530
E: cjdias@kpmg.com

Stacy Keating
Partner
Financial Services Advistory
T: 212-954-3453
E: sekeating@kpmg.com

Chris Long
Principal
Financial Services Advisory
T: 862-222-4941
E: chrislong@kpmg.com

Mark Twerdok
Partner
Financial Services Advisory
T: 412-232-1599
E: mtwerdok@kpmg.com

Jason Bui
Director
Financial Services Advistory
T: 212-954-3110
E: jasonbui@kpmg.com

Timothy Cerino
Director
Financial Services Advistory
T: 212-954-1069
E: tcerino@kpmg.com

Turgay Mehmet
Director
Financial Services Advisory
T: 646-249-9494
E: tehmet@kpmg.com

Contributing authors:
Christopher Dias, Principal, Financial Services Advisory
Amy Matsuo, Principal and Lead, Regulatory Insights
Karen Staines, Director, Financial Services Regulatory Insight Center.

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