Moving to new risk-free rates

Why asset managers need to prepare for the transition from IBORs

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Introduction

European and national regulators are focused on the implications of transition to the new risk-free rates (RFRs). This paper highlights the factors impacting the industry, what buy-side firms should consider and where they should start.

The UK's Financial Conduct Authority (FCA) announced in July 2017 that it will not compel or persuade panel banks to make LIBOR[1] submissions after the end of 2021. This declaration unleashed a flurry of activity around not only choosing alternative reference rates but also developing the roadmap needed for transitioning to the new RFRs.

The minutes[2] of the October 2018 meeting of the working group on Euro risk-free rates noted the pressing need for the financial industry to tackle the challenges of interest rate benchmark reforms. In its 2018 Markets and Risk Outlook,[3] the French AMF[4] noted that the legal validity of existing financial instruments and contracts could be called into question, and that changes in reference rates could lead to significant portfolio reallocations.

With a majority of sell-side firms already planning for the transition, KPMG professionals have so far seen fewer buy-side firms thinking about the impact the transition will have on their clients' portfolios, and their agreements with counterparties and provider agreements.

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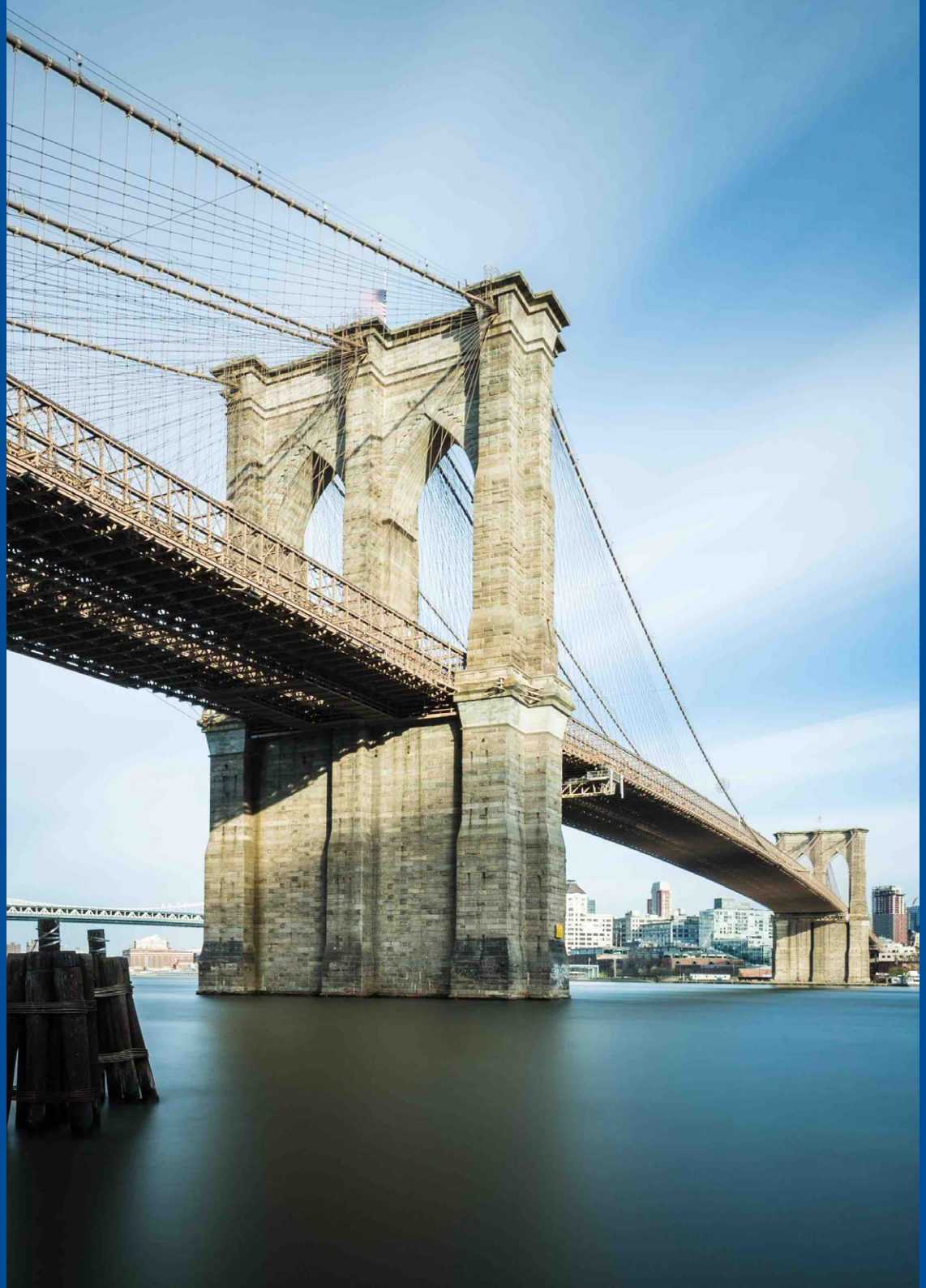
[1] London Inter-Bank Offered Rate

[2] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/20181018/2018_10_18_WG_on_euro_RFR_meeting_Minutes.pdf

[3] https://www.amf-france.org/en_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FSpacesStore%2F543a184a-4e98-466d-84eb-27e97e120ce5, page 50

[4] Autorité des Marchés Financiers



> 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.
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> 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, Chief Executive Officer, International Swaps and Derivatives Association (ISDA), 4 July 2018*

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 (TONA)	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

[5] 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

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

Background

Inter-Bank Offered Rate (IBOR) is used as reference rate or benchmark of the average rate at which banks are able to borrow from one another in the short-term money markets. LIBOR is one of a number of interbank offered rates currently in use. It is calculated daily based on rates quoted by a panel of banks for five currencies and across seven maturities.

The combined gross notional exposure of contracts referenced to these interbank offered rates was estimated by the Financial Stability Board (FSB) at more than USD 370 trillion in 2014.[5] At the end of 2016, the estimated total exposure to USD LIBOR alone was nearly USD 200 trillion, spanning a broad range of market participants in a variety of products.[6]

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 having them underpinned by transactional data.

The FSB also recommended developing alternative, nearly risk-free reference rates. To that end, five currency Working Groups – USD, GBP, JPY, CHF and EUR – were formed to consider, recommend and promote alternative RFRs within their home jurisdictions. The five recommended alternative RFRs are being developed as primarily transactions-based and tied to overnight borrowing rates.

Key challenges for asset managers

Value transfers: Internal valuation models will need to be calibrated for replacement RFRs. Firms will need to identify and establish where IBORs have been used and determine how to transition away from these in an orderly manner. The transition to an overnight RFR will lead to changes in the value of existing positions, which could be more or less favourable to counterparties.

Contracts and fund documentation: Investment Management Agreements and fund documentation may reference IBORs for benchmark purposes. Firms should look to minimise the time before more robust contract language is widely incorporated, which may involve being willing to change language over time rather than forgoing any changes until absolute certainty is achieved.

Hedging and basis risk: For many hedging instruments, such as swaps and forwards, the floating leg rate references an IBOR. With the move to alternative RFRs and questions around availability and liquidity of alternative rate instruments, there is a risk that hedging strategies begin to contain different reference rates and exposures that do not perfectly net. Firms need carefully to plan their transitions from the IBOR to manage this basis risk.

Cross-currency trades: The different regional approaches, and the co-existence of IBORs and alternative RFRs, will have implications for cross-currency transactions and hedges, particularly around basis risks. Alternative RFRs adopted for different currencies will have uneven liquidity conditions, at least for an initial period.

Liability-driven investment: LDI strategies are by their very nature long-dated. The potential end of LIBOR in 2021 will likely impact these derivative portfolios. Asset managers will be making plans to assess the impact and agree a time line to transition risk.

Exchange-Traded Funds: The use of swaps to gain exposure to an index without holding the underlying securities is commonplace for synthetic ETFs. For many, the floating leg of a swap is a reference rate, typically an IBOR, which is exchanged for the return on the equity index. With the move to alternative RFRs that may not include a credit risk premium, managers and authorised participants and investors need to understand the impact of this and how the funds are constructed.

Where should Asset Managers start?

RFR programme set-up – Firms need to develop and manage a cross-functional RFR programme that handles all business lines and the jurisdictional differences. Certain areas will have critical issues that need to be linked across these programs. Sifting these from wider noise will be key to making these programmes effective.

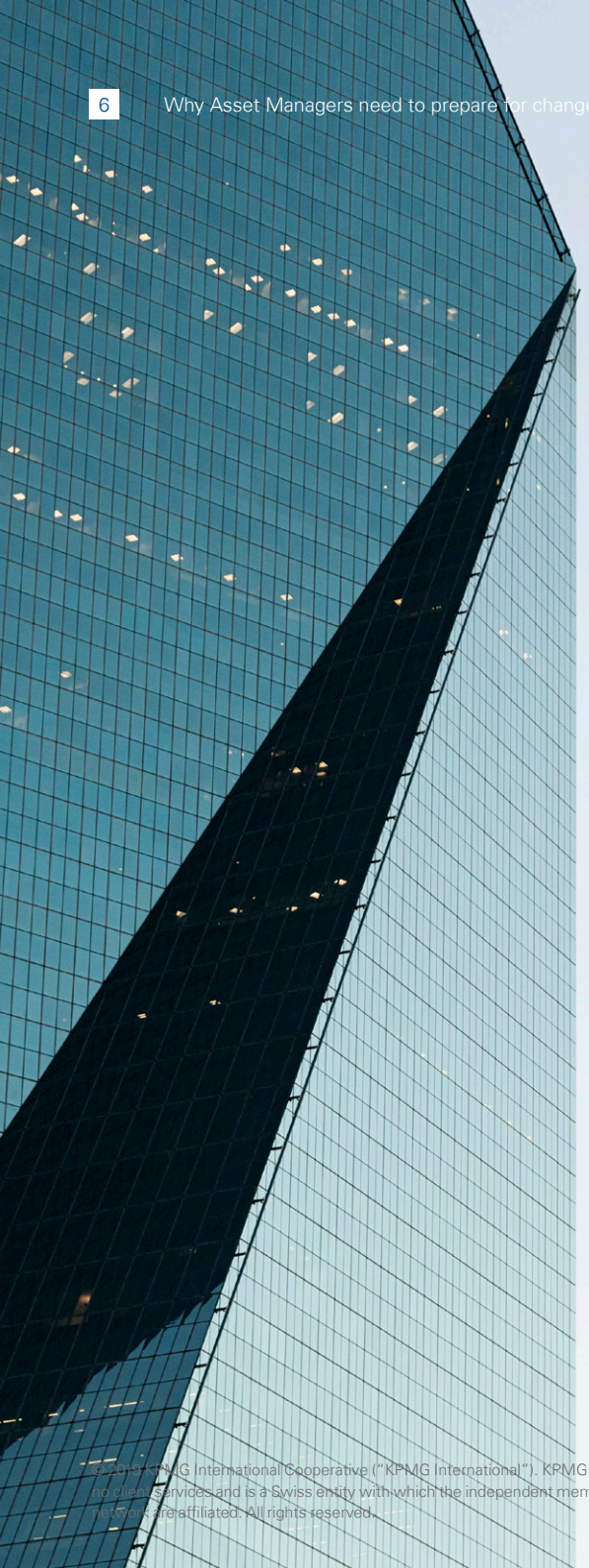
Initial impact assessment – This will need to encompass modelling and systems analysis in all business units to consider issues such as operational, legal and conduct risk, functional impacts and economic implications for firms and clients. Global organisations have the additional complexity of needing to consider regional transitions and timings.

Strategic Planning – Based on economic impacts to the existing portfolio and the potential business opportunities arising from the use of new RFRs, firms should (i) establish client communication and negotiation workflows, (ii) review contract structure and (iii) evaluate profitability, cash-flows and hedging risk.

Governance and client outreach – Firms will need to develop internal governance processes to approve changes to policies, systems, processes and controls. It will be imperative to ensure that clients are being treated fairly through the transition. Firms will need to educate client-facing staff on the transition implications so they can guide clients transparently and fairly through the process.

Contract identification – Through a scalable process (leveraging technology if possible), firms need to identify all products and business lines, including expected fall-backs, and the bilateral negotiations likely to be in scope. ISDA will play a key role in shaping the derivative market transition, but other cash products (for example, floating rate notes) typically are not standardised contracts and can involve additional legal jurisdiction complexities.

IBOR exposures and risk management – Firms need to have a clear measure of IBOR exposure broken down by maturity beyond 2021. Ideally the exposure should be grouped by fund, portfolio and counterparty. This data will be a building block for the programme, to help assess the risks and progress of the transition going forward.



Industry building blocks required for a smooth transition

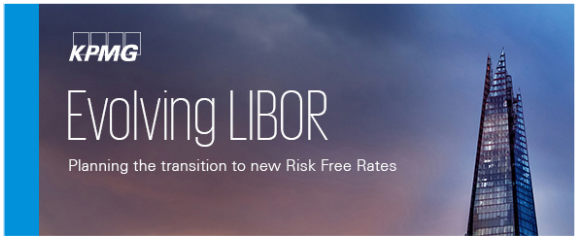
Industry participants need collectively to try to agree key building blocks to ensure a smooth transition:

- **Clear and detailed industry timelines:** A structured timeline and approach is required, which includes all regions, products and industries.
- **Market adoption:** In order to increase and maintain liquidity in the RFR market, firms need to ensure that they collectively adopt RFRs going forward. As RFR liquidity increases, IBOR liquidity will proportionately decrease as firms transition to the alternative reference rate. There will therefore be an optimal time for the transition.
- **Client awareness and outreach:** Market participants need to ensure that internal stakeholders and end clients are made aware of the transition and the impact this could have to existing and new positions.
- **Technical developments (e.g. fall-backs, term rates and ISDA protocols):** The new RFRs are overnight indices and currently have no term structure, unlike IBORs. This will likely result in differences in product valuations and hedging arrangements. Developments are currently underway for new products, mechanisms and industry protocols to support the transition.

How KPMG can help

We understand the global complexity of this transition and recognise the need for strategic planning with minimal disruption to your fund and client portfolios, and to your operations. Our experienced team are actively engaged with regulators and industry participants globally, across banks, asset managers and corporates. As a result, we have an in-depth knowledge of the challenges faced by the industry and have developed solutions that can assist your organisation with the transition to the new rates.

Recent insights published by the EMA Financial Services Risk & Regulatory Insight Centre (RRIC) include:



Evolving LIBOR – June 2018
This report provides insight into scenario planning for a successful transition.

Evolving LIBOR series
We are producing regular content – the Evolving LIBOR series – to help firms easily digest the complex changes transitioning from LIBOR to Risk Free Rates may generate.

Horizons
The outlook for financial services regulation. This publication is your 'go to' read for insights on financial services regulation from the perspective of the EMA region.

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