IBOR transition

A certainty not a choice

Building a better working world

In July 2018, regulators and industry groups launched an intensified, carefully coordinated global push for firms to recognize the pressing circumstances surrounding interbank offer rates (IBORs) and hasten efforts to phase-out products referencing IBORs and transition to alternate reference rates (ARRs).

First, to demonstrate the strong global coordination between the UK and US regulators, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA) UK, and J. Christopher Giancarlo, Chairman of the Commodity Futures Trading Commission (CFTC) US, simultaneously underscored the inevitable discontinuation of IBORs post 2021. Both expressed an urgent need for all financial market participants to actively reduce their exposures to IBORs and transition to products referencing ARRs, so that global financial markets will remain safe and sound. In addition, the Financial Stability Board (FSB) released a statement encouraging the development and adoption of overnight and term risk-free rates, and a proactive discussion among financial market participants that may be impacted by the IBOR transition.

Second, the International Swap and Derivatives Association (ISDA) published its much-anticipated consultation on Fallbacks for Derivatives Contracts that reference certain IBORs. This consultation is critical to developing contractual fallback language, so that a permanent end to IBORs does not result in disruption, contract frustration and financial market instability.

Third, the consultation on the assessment of candidate EUR ARRs closed on July 13, 2018. It represents an important step in selecting an ARR for EUR-denominated IBORs, the absence of which has been an industry concern in light of the accelerated transition deadline of European Benchmark Regulation by January 1, 2020. Recommendations are expected to be announced at the fifth ECB workshop on September 13, 2018.

Finally, the Alternative Reference Rate Committee (ARRC) in the US released the Principles for Fallback Contract Language for new financial contracts (cash products) that reference USD LIBOR so they will continue to be effective in the event that USD LIBOR is no longer published.

IBOR transition – progress-to-date for ARRs

In July 2013, the FSB established the Official Sector Steering Group (OSSG), comprised of senior officials from central banks and regulatory agencies, to focus on interest rate reform. The following July, the FSB recommended the development of ARRs and a transition away from IBORs across all major currencies. In addition to the FSB report, the IOSCO Principles for Financial Benchmarks (2013) and EU Benchmark Regulation (2017) provided additional impetus for interest rate benchmark reform.

Since then, working groups across all major currencies have been formed to select ARRs and provide an orderly transition. ARRs have been selected for four major currencies: SONIA (GBP), SOFR (USD), TONA (JPY), and SARON (CHF). The selection of the Euro ARR remains a work-in-progress.

IBOR transition – progress on new products

In addition to the selection of ARRs, significant progress has been made in developing market liquidity for the ARR in derivatives markets; for example, SOFR and SONIA futures have been launched and the volume of contracts traded continues to increase. The London Clearing House (LCH) began clearing the SOFR-based over-the-counter cleared overnight index and basis swaps and the Chicago Mercantile Exchange (CME) is preparing for the launch of similar products later in Q3 of this year. In addition, a SARON swap market has been established in Switzerland, to be followed by the introduction of SARON futures. Progress is also noted in cash markets with the European Investment Bank (EIB) launching a SONIA-linked Floating Rate Note – the first floating rate note linked to SONIA since 2010.

Moreover, ISDA and other trade associations (AFME and LMA) and cash product working groups have focused on developing robust fallback language for new financial contracts to mitigate the risk of a permanent end to IBORs.

Finally, to enable broad representation in transition planning and market adoption of the new ARRs, working groups have extended their participation to a broad range of financial and non-financial firms. The working groups also have formed outreach and communication sub-working groups to enhance the level of education and understanding of IBOR reform across retail and corporate end-users.

Despite significant progress by market participants in the selection of ARRs and transition planning, there is still a lack of broad market awareness and understanding of the need to transition away from IBORs to ARRs. Even among the largest financial institutions, there is significant complacency and potentially misplaced hope that IBORs will continue beyond 2021. This view was confirmed in the most recent global market survey by ISDA and other trade associations, where it was noted that although 87% of survey participants were concerned about their institutions' exposure to IBORs, only 11% had allocated budget and resources to support a transition program.[1]

> "The discontinuation of LIBOR is not a possibility. It is a certainty. We must anticipate it, we must accommodate it and we must adapt to it."
> - CFTC: J. Christopher Giancarlo, July 12, 2018

[1] IBOR Global Benchmark Transition Report (June 2018)

Regulatory agencies address key issues

The US and UK regulatory agencies reiterated the need to transition away from IBORs to ARRs due to dwindling transactions in the interbank wholesale funding markets; extensive use of IBORs in derivatives markets where a risk-free rate is more appropriate; use of expert judgment in IBOR submission; and the potential risk of misconduct.

The regulatory agencies emphasized that the end of IBORs is not a mere possibility but a certainty, and IBOR, in any form, will not be a suitable rate for new transactions beyond 2021.

Speeches by the agencies clarified a number of points that are critical for transition planning, as summarized below:

- **Derivatives transactions** should be based on ARRs and not IBORs. Overnight risk-free rates are more suitable for hedging general interest rate risk than for LIBOR, which incorporates bank credit risk and term premium. Also, it was mentioned that the definition and availability of term rates is not critical for the transition of derivative markets to ARRs – a topic which continues to be a focal point for decision-making among industry participants.
- Regulatory agencies acknowledged that the availability of **forward-looking term rates** will be crucial for the transition of some cash products. Working groups are focusing on the definition of forward-looking term rates based on observable transactions in the derivatives markets. Definition of term rates based on backward compounding of overnight ARRs will not provide the certainty of cash flows desired by retail and corporate end-users.
- **Legacy transactions and contracts** maturing after 2021 linked to IBORs that do not have a robust fallback language will require contract amendments to mitigate the risk of a permanent end to IBORs. The amendment to the fallback language clearly should define the trigger event, successor rate (ARR), spread adjustment, timing and operational mechanics to minimize potential value transfer and contract frustration.
- **Legacy transactions and contracts** maturing after 2021 linked to IBORs should be migrated to ARRs, where feasible. Regulatory agencies may authorize the continued use of IBOR for legacy transactions where a transition to an ARR is not feasible due to unsurmountable legal and operational challenges; for example, bonds where majority or unanimous consent is required to change contract terms. The feasibility of LIBOR's continued use for legacy transactions will depend on the availability of LIBOR publications and the outcome of work undertaken by ICE's Benchmark Administration.
- IBORs will not be suitable for **new transactions** beyond 2021, given the structural weaknesses noted in the current IBOR and the uncertainty over its continuance. EONIA or EURIBOR cannot be used in new contracts beyond 2019 due to the go-live date of EU Benchmark Regulation.
- **Synthetic LIBOR,** first proposed in a speech by Andrew Bailey (March 2018) and defined as an ARR plus term credit premium, is no longer a feasible solution due to unsurmountable challenges in the definition of a market observable term credit premium.
- The transition from IBORs to ARRs is an industry-led initiative supported and facilitated by regulators. The supervised financial services firms should be prepared to demonstrate plans to reduce dependencies on IBORs, and transition to ARRs, as part of the **supervisory review**. If market participants are unable to voluntarily transition from IBORs to ARRs, then the regulators stand ready to use the tools at their disposal to facilitate the transition.

ISDA consultation on fallback language for derivatives

This consultation establishes options for adjustments that would apply to the fallback rate in the event an IBOR is permanently discontinued. It aims to address two structural differences between IBORs and ARRs – term and credit premium – to safeguard that legacy derivative contracts function as closely as possible to their intended use if a fallback is triggered.

Term to overnight rate: The four options ISDA proposed for moving from a term rate to an overnight rate are based on two core approaches: a spot-rate approach or a compounded rate approach. For the spot rate approach, the ARR fallback rate would either be (1) fixed or (2) adjusted to account for the difference between the spot overnight fallback rate and the realized rate of interest over the referenced IBOR's term. For the compounded rate approach, the alternative RFR fallback rate would either be (3) set in arrears or (4) set in advance. Under both compounding approaches, the ARR fallback rate would take into account the actual daily interest rate movements either at the beginning ("advance") or the end ("arrears") of the IBOR tenor period.

Credit premium: The three credit premium adjustment options that ISDA proposed would be fixed at the point the fallback rate is triggered. The proposed approaches are: (1) a forward approach based on a forward-looking spread between the IBOR and ARR; (2) a historical approach based on the spread between the IBOR and the ARR over the 5-year or 10-year historical period; and (3) a spot-spread approach which is similar to the historical approach but over a shorter historical period (e.g., one week, two weeks, one month).

The consultation is open to all derivative market participants and will run for three months until October 12, 2018. Results from the fallback consultation will be included in the ISDA definitions for interest rate derivatives and apply to new IBOR trades. ISDA also will publish a protocol to allow participants to include the fallbacks within legacy IBOR contracts, if they choose to do so.

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ARRC guiding principles on fallback language for cash products

The ARRC has released guiding principles for newly-issued cash products referencing LIBOR (e.g., business loans, securitizations and floating rate notes). These are intended for market participants to voluntarily use as they look to restructure contract language for cash products. The guiding principles provide a framework for the use of fallback or successor rates, credit spread adjustments and trigger events, and stress the urgency to incorporate the replacement language into new contracts to reduce the potential increased risk in the financial system.

In the principles, the ARRC acknowledges that suggested contract language initially may include higher degrees of flexibility for quicker incorporation. However, it is not expected to evolve to be more specific as market consensus emerges, and the fallback language should seek to minimize litigation, judicial and regulatory risks. The ARRC encourages market participants to propose solutions that are consistent between asset classes (to the extent possible); minimize the basis risk both between products and across multi-currency facilities; and reduce the potential value transfer if a fallback rate were to be triggered.

Within the principles, the ARRC highlights the need for open communication between borrowers and investors to develop solutions that work for all market segments. They recommend that firms internally analyze the impact(s) of the current fallback language in their legacy portfolio, including how a successor rate may behave under different economic conditions. They explicitly state that solutions should seek to use SOFR, or a benchmark based on SOFR, as the primary basis for a replacement rate.

The release of the principles is yet another indication that the market, along with the regulatory community, is supportive of the transition. Significant efforts are underway to plan for the potential cessation of IBORs.

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What should firms do today?

1. Identify and **nominate a senior executive** – IBOR transition executive
2. Mobilize an IBOR transition program office
3. Conduct a comprehensive impact assessment across products, legal contracts, risk exposures, models, business processes and infrastructure
4. Prepare to offer new products and financial instruments linked to ARRs
5. Develop an inventory of legacy exposures and contracts that mature after 2021
6. Define an enterprise-wide governance framework
7. Define a knowledge and education strategy
8. Define a client outreach and communication strategy
9. Communicate to the board and executive management committee
10. Prepare for onsite supervisory examination

What should firms do today?

1. **Identify and nominate a senior executive (IBOR transition executive)** responsible for assessing, planning and coordinating all IBOR transition activities across the enterprise and making sure that the firm is proactively engaged in a smooth and orderly transition to ARRs. In addition, identify business sponsors for all impacted core business lines and enterprise functions (e.g., risk, finance and treasury).

2. **Mobilize an IBOR transition program office** to coordinate transition activities across the enterprise. Identify and align resources with deep knowledge and expertise across large-scale transformation and complex program management, products and financial instruments, legal contracts, processes, data and technology, accounting, valuation and risk management.

3. **Conduct a comprehensive impact assessment** of IBOR transition across the firm. The impact assessment, at a minimum, should cover:

    a. Product assessment: Identification and assessment of products, instruments, and business activities linked to IBOR, including nominal exposure, contractual and behavioral maturity, optionality and client segment.

    b. Legal contract assessment: Identification and assessment of the contractual language of the impacted products, especially their fallback options in case IBOR is discontinued.

    c. Risk assessment: Identification and assessment of the impact of IBOR transition on the risk profile of the firm (e.g., potential increase in basis risk and operational risk) and financial resources (earnings, capital, funding and liquidity) based on a range of scenarios.

    d. Model assessment: Identification and assessment of models and end-user computing tools (pricing, valuation and risk models) that are linked to IBOR and may require model redevelopment and validation. The development of new products and instruments linked to ARRs would require new model development and approval.

    e. Business process and infrastructure: Identification and assessment of business processes, data sources, and applications that may require update and or re-development. Where the firm has dependency on third-party packaged application providers, it should proactively engage with vendors to understand their product upgrade lifecycle for IBOR transition.

4. **Prepare to offer new products and financial instruments linked to ARRs** in derivative and cash markets, and develop required contract and fallback language, pricing, risk, operations and technology change to support the new products (new product approval).

5. **Develop an inventory of legacy exposures and contracts that mature after 2021** (or 2019 for EONIA and Euribor). Address the risk of an ongoing exposure to IBOR, especially by amending the fallback language, and enhance risk disclosures. Where possible, minimize the IBOR exposure by moving new products to ARRs.

6. **Define an enterprise-wide governance framework** for the IBOR transition program, provide regular updates to the Board (or a designated sub-committee), and executive management on risks and issues; define terms of reference and membership for the steering committee; define program charter and work streams, risks and issues log, key design decisions, internal and external dependencies, communication plan and roadmap; and preliminary resource and cost estimates.

7. **Define a knowledge and education strategy** for all internal stakeholders to heighten awareness of risks and issues, transition challenges, and the firm's transition plan. Prepare the client relationship management team to proactively engage in discussions with retail and wholesale end-users of IBOR-linked products to increase awareness, communicate the transition plan, timelines, potential impact on end-users, and operational mechanics of repapering and repricing, where relevant.

8. **Define a client outreach and communication strategy** for all external stakeholders (customers, counterparties, investors, rating agencies and regulatory agencies) on the potential impact of IBOR transition on their activities with the firm. Coordinate with industry working groups to define the collective versus firm-specific communication plan, taking into account any potential anti-competitive issues.

9. **Communicate to the board and executive management committee** on the firm's exposures to IBOR-linked products and financial instruments, legal contracts, business processes, and technology infrastructure; the impact of IBOR transition on the firm's changing risk profile; potential impact on financial resources; program governance; transition roadmap; and business case.

10. **Prepare for an onsite supervisory examination** that assesses the state of readiness to transition from IBOR's to ARR's; strengthen capabilities to respond to data requests on IBOR exposure by global regulators in a controlled environment; and proactively engage and contribute to working groups facilitated by regulators and industry trade associations.

Conclusion

IBOR's transition is far from complete. The pace of change is picking up, driven by regulators and industry groups who believe that IBOR's transition is essential and that existing contracts need to be addressed to the extent practicable.

As highlighted in the ISDA survey, firms should take action now: kicking off impact assessment and establishing program governance. We expect that there will be greater focus on IBOR as boards and other stakeholders, counterparties and regulators, press for updates and continue proactive discussions.

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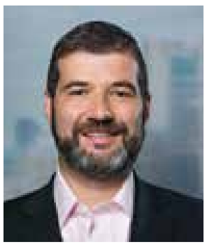

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