IBOR transition: a business challenge requiring a strategic response

Interbank Offered Rate (IBOR) transition is a business challenge and an opportunity. Realizing the commercial advantages requires organizations to master the transition challenge – and keep commercial issues a priority throughout the program.

IBOR shouldn't be seen as a chore – but rather as a business issue with the potential to impact both profit and loss, and capital.

As banks develop new products and financial instruments in the new Alternate Reference Rate (ARR) environment, some are holding refinancing discussions with clients. They are engaging with them six to nine months before their loan facility expires, and proposing options, including new products based on a new risk-free rate. To facilitate development of a sound transition strategy, banks are building a holistic picture of their clients' exposure to IBORs by product (cash and derivatives), currency, reference rate and maturity.

Why are financial services firms taking action now? Because they realize that IBOR transition is not just a technical compliance challenge that can be addressed by updating systems and processes in an isolated manner. It's a business model, product and pricing strategy, and a client engagement issue that potentially has a real financial impact. Banks are also proactively managing and mitigating potential conduct risk that may arise from continuing to offer IBOR-linked products knowing that the reference rates may not exist beyond 2022.

Financial impact

Understanding the business challenge starts by identifying multiple ways in which IBOR transition could have an adverse financial impact on the bank and its clients and counterparties. Assuming that market standard fallback language is agreed and implemented, triggering this fallback will inevitably cause value transfer – creating winners and losers.

Banks have to measure and manage the potential profit-and-loss impact on banking and trading books. They need to understand that counterparties losing out from the change may feel they have been treated unfairly and choose to litigate. Some banks have quantified the financial impact of walking away from in-the -money contracts due to potential legal, reputation and conduct risk. Others are assessing the potential impact on basis risk by failing to amend fallback language in legacy transactions. As the market becomes more fragmented, increased basis risk will potentially increase the amount of capital banks need to hold for market and interest rate risk.

In addition, lack of historical data for the new ARRs could threaten the viability of internal models to measure capital requirements. Inability to transition hundreds of financial models from IBOR to ARR within a compressed period of time could adversely impact capital.

There's also the impact of stress-testing requirements – particularly if a bank has failed to make adequate preparations for its IBOR transition and has trillions of dollars of exposure. Starting in Q4 2018, global regulators have asked firms to assess program readiness and provide details on governance, exposures and risk assessment. Low self-assessment scores without an appropriate mitigating action plan could result in an operational risk capital surcharge.

Finally, there's the inevitable operational cost of implementing IBOR transition, including:

- Designing new products
- Changing systems and processes
- Revising validation risk and finance models
- Digitizing and repapering contracts
- Operationalizing fallback language
- Addressing legal issues and undertaking a major communications exercise

Together, these tasks represent a massive enterprise-change program, requiring sponsorship at the most senior level within the bank, robust governance, and regular updates to the board and management.

IBOR transition is clearly a big challenge – from a strategic, business and operational perspective – and it affects parts of the business differently: derivatives trading, for example.

The International Swaps and Derivatives Association (ISDA) is developing a protocol to allow banks to change numerous contracts at the same time. In the derivatives market, systems are relatively agile, so although the nominal size of derivatives exposures linked to IBOR is significant, adjusting to the new ARRs shouldn't be a huge conceptual shock. The applicability of netting sets, compression utility, engagement of exchanges, central clearing counterparties, and other financial market infrastructure providers will ensure a smooth and orderly transition of the derivatives markets.

Break the problem down

The challenge is somewhat different in wholesale and commercial banking, where explaining what's changing and why to large numbers of clients will prove a major exercise. The retail banking challenge will be significant in regions where mortgage rates are often linked to IBORs, such as the US, Spain and Italy.

Whatever your specific area of banking, the key is to focus on what action to take now. Organizations could prioritize efforts in three key areas:

1. **Develop new product and pricing strategy.** Consider the feasibility and business appetite for offering new products, and shift focus from a product-centric to a client-centric strategy. Be ready to satisfy client requests or risk losing potential valuable customer relationships. The new ARR pricing and risk models should reflect current market liquidity levels and methodologies that will adapt over time.

   The transition also presents opportunities for investment banking and global markets' business lines to advise, structure, and offer solutions to financial services and non-financial services firms that would like to transition their funding (floating rate notes) and hedging activities to ARRs.

   We are seeing growing momentum in both the cash and derivative ARR markets, with the emergence of ARR-linked futures, swaps, floating rate notes, asset-backed commercial paper and contracts. Offering new products using the new ARRs not only meets market demand, but also begins reducing the scale of the London Interbank Offered Rate (LIBOR) legacy contract challenge.

2. **Review your contracts.** Many contracts underpinned by LIBOR will still be running in 2021 and beyond. Therefore, it's advisable to start contract and fallback language analysis and remediation to protect against a trigger event. The task is significant, given the huge volume of affected contracts, limited inventory and current digitization of those contracts.

   In the past, banks did not systemically capture fallback language embedded in financial contracts in client onboarding, legal, trade or loan booking systems. In the absence of IBORs, banks will need to manually source fallback language across thousands of impacted contracts and amend the index across hundreds of systems to avoid disrupting receipts and coupon payments. Banks need to capture fallback language at the inception of all new contracts and mobilize a significant remediation effort to address the legacy portfolio.

3. **Develop client communication strategy.** Proactive communication with clients and counterparties will be critical to ensure a smooth and orderly transition and manage legal, reputation and to conduct risk.

   Initially, the client communication strategy should ensure consistent response to inbound client inquiries on the background and rationale for transition, new product offering, and legacy portfolio transition. More detailed engagement should focus on how an individual client's facilities are affected and future product needs. Webinars and external websites may be helpful for general inquiries, but these should be complemented with meetings, conferences and town halls for wholesale and business banking clients.

Businesses must take the lead

This is not a regulator-enforced challenge. Yes, regulators want to move away from IBORs. They perceive them as based on judgment and inherently less reliable than the new ARRs, which will be transaction-based and more robust over the longer term. But regulators cannot provide all the answers. The financial sector developed IBORs and is expected to find better alternatives and implement them in a well-managed and effective way.

IBOR transition is a certainty and not a choice. It's an opportunity to engage with clients, reassess the bank's product and pricing strategy, and build a more robust and resilient financial market ecosystem. Adopting a more positive approach to IBOR – as many banks have started to do – can go a long way.

Banks must take action now. Every step makes the size and scale of the problem smaller, reduces risk and creates a stronger competitive position to take advantage of market opportunities.

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