The sun sets on LIBOR

Many non-financial corporations are not transition-ready

KPMG International

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Ready, set... no

After more than 30 years, the London Interbank Offered Rate (LIBOR), the reference rate for hundreds of trillions of dollars across a broad array of global financial products, will sunset for new deals, as of year-end 2021.

LIBOR has long been the industry's go-to benchmark for short-term lending. While financial institutions have been preparing for LIBOR's cessation since the introduction of LIBOR's US alternative, the Secured Overnight Financing Rate (SOFR), in 2018, non-financial companies have been trailing in progress significantly. Whether it's planning for the transition of existing contracts referencing LIBOR or choosing a new alternative that suits their needs for financial deals going forward, non-financial companies should have a plan in place to ensure the transition minimizes internal financial and operational impacts and to avoid widespread disruption to financial markets, products, and participants.

But do they have a plan?

In our recent *LIBOR transition corporate survey*, 45 percent of respondents told us they had not started any transition projects or initiatives. Additionally, a KPMG review of 2019 year-end 10k filings by non-financial firms in the S&P 500 revealed that only 16 percent of these firms cited the cessation of LIBOR as an industry risk.

Why is this? For many organizations, it's a combination of a lack of clarity regarding their existing LIBOR exposure, confusion over the most appropriate SOFR conventions (e.g., in arrears vs. in advance), and overall financial and systems unreadiness.

A key operational challenge will be navigating the disparate requirements of legacy and new transactions. For example, legacy trades may require firms to temporarily maintain existing LIBOR related infrastructure to facilitate pricing, valuation, accounting and risk-related activities. However, new transactions, based on the new Risk Free Rate (RFR), will require new booking, accounting and risk-related processes and modified systems, which could create technology, training and compliance issues.

On 5 March 2021 the FCA has announced the dates that **panel bank submissions for all LIBOR settings will cease**, after which representative LIBOR rates will no longer be available even for legacy transactions from 30 June 2023.

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Survey says: Not prepared

Despite the fact that the anticipated end of LIBOR has been promoted for several years, research suggests transition efforts at many non-financial companies may not be as far along as they should be and could be preventing final adoption of replacements for LIBOR in the market. To help corporations stay on top of these factors the Alternative Reference Rates Committee (ARRC) has convened a non-financial working group that focuses on a number of transition challenges and issues from the non-financial lens, from vendor readiness and intercompany and customer loans, to systems, structures and conventions.

With the potential discontinuation of LIBOR upon us, we feel it is important to understand the readiness of transition efforts not only for financial institutions, but for corporations as well.

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The time has come to accelerate LIBOR transition preparation

Although most non-financial organizations are well aware at this point of the pending transition away from LIBOR, many are behind in their preparation. It appears firms are holding back as they wait for ARRC to reinforce support for SOFR term rates, or in an effort to delay the inevitable costs of upgrading systems. In a survey of non-financial companies, 60 percent said they had not started any LIBOR transition activities, such as setting up a task force or project team and any related committees, and some of them were not planning to.

The fact that the **majority of companies have not started** down the transition path at all **raises concerns**.

Has your company started LIBOR transition project initiatives?

Response	Percent
Yes — Already in place	39%
No — But will be set up in the next 3 months	15%
No — Not on the immediate horizon	45%

Source: The sun sets on LIBOR, 2021

The fact that the majority of companies have not started down the transition path at all raises concerns. Companies that don't have a LIBOR transition program in place could find themselves in a difficult position because they simply don't know what transactions and contracts they need to remediate. Of course, they will be advised by their banks when the time comes, but companies without a well-defined strategy are likely to experience operational complications as a result of uncertainty around term structures, liquidity and regulatory guidance, to name just a few.

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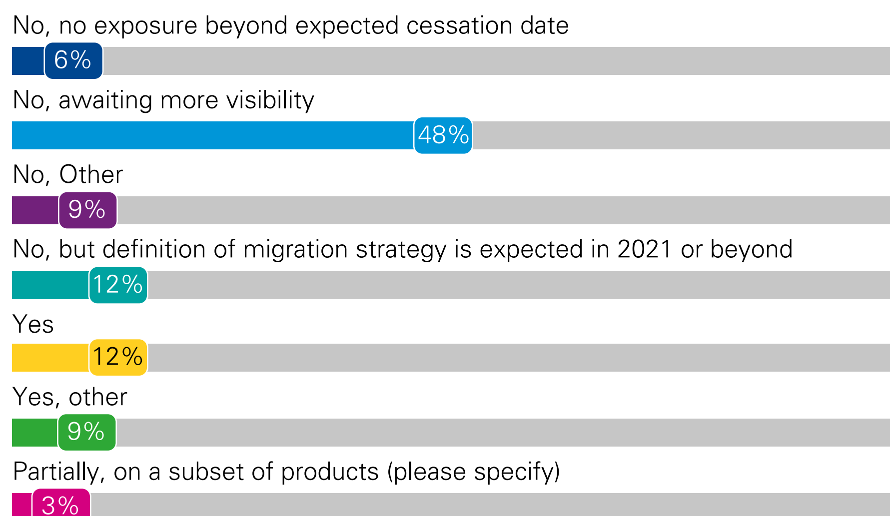
Know your exposure

LIBOR is the reference rate for a vast array of financial products and operational processes, from loans and derivatives to insurance contracts, leases and mortgages. The importance of a clear, up-to-date inventory of all impacted contracts cannot be overstated. Companies are encouraged to identify all products that will likely be in play for the transition and analyze the legal language in an effort to both assess the scale of the project and determine the most appropriate strategy for successfully navigating the inevitable contractual changes and mitigating internal and external risks.

According to a survey of non-financial companies, however, many seem to be taking a 'wait-and-see' approach, with nearly half (48 percent) awaiting more visibility into the many unresolved operational elements of the transition before finalizing their strategies.

The survey also explored companies' expectations for **continuing to enter into new agreements that reference LIBOR.**

Have you defined a migration strategy for legacy contracts?



Source: The sun sets on LIBOR, 2021

The survey also explored companies' expectations for continuing to enter into new agreements that reference LIBOR. The majority of respondents said they would continue until LIBOR is no longer deemed to be representative by the market. This suggests borrowers realize that lenders have adopted, or will soon adopt, a 'hardwired' approach to reference rate conversion in which the replacement benchmark (SOFR) is specifically designated as opposed to being specified through incremental amendments to the contract that may not initially identify the new rate.

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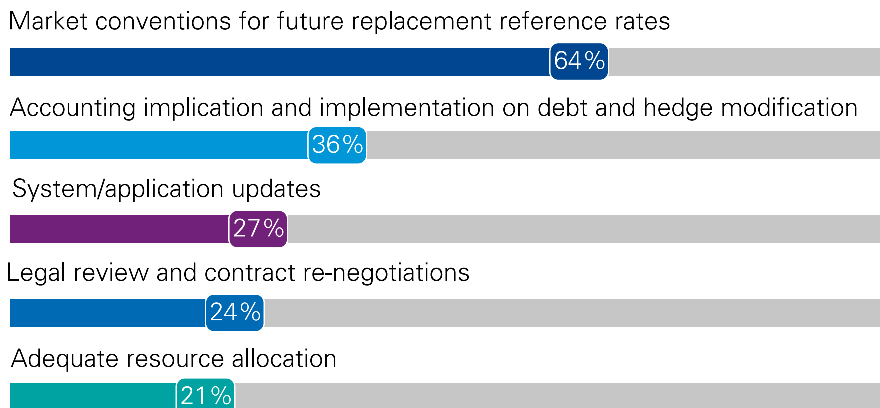
Conversion obstacles

There is a lack of certainty among market participants around the post-LIBOR landscape — for example, timing of Term SOFR, what pricing will look like, and the level of liquidity of SOFR. Indeed, our aforementioned review of 2019 year-end 10k filings by non-financial firms in the S&P 500 found that 39 percent see the transition of LIBOR to an alternative reference rate as a risk, albeit only in relation to its potential impact on assets. Twenty eight percent reported that they had identified qualitative risks associated with the transition, including commentary around managing legacy and future financing arrangements.

By far, respondents said their greatest challenge in arranging deals referencing SOFR is expected to be prevailing market conditions which, considering the ongoing disruption brought about by the COVID-19 pandemic, will be difficult to unstable.

What is your biggest challenge as you prepare for LIBOR transition?

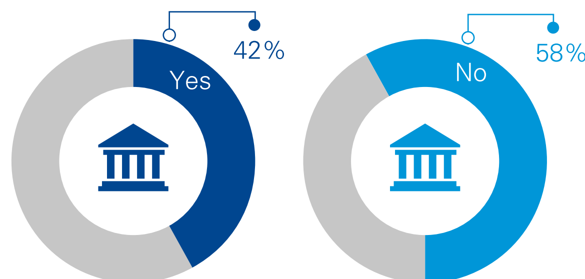


Source: The sun sets on LIBOR, 2021

As for guidance issues, when asked whether their banks have described the more technical implications of the transition, such as pricing, nearly 60 percent said no. This feedback is not surprising as many banks aren't ready to explain pricing in detail at this point because they themselves don't know precisely how it will work.

Have your banks described the operational and price implications of the alternatives to LIBOR?

Source: The sun sets on LIBOR, 2021



Without this clarity it is difficult for corporations to effectively plan, allocate resources and budget. Clearly, the full implications of this transition are not well understood.

Corporations can identify where LIBOR is referenced across their many agreements, but they are largely price takers and need the market — regulators and banks — to help them identify a clear path forward.

There is a **lack of certainty among market participants** around the post-LIBOR landscape...

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Alternative reference rate adoption

While LIBOR's exit as a reference rate is certain, the market's acceptance of SOFR and the development of liquidity and term structures is not. Even less so is the extent to which the transition to an alternative reference rate will impact firms operationally beyond debt issuance and derivatives.

Although ARRC has articulated an ultimate goal of a forward-looking term rate for SOFR at tenors that follow the existing structure of LIBOR, non-financial companies should become familiar with the spectrum of SOFR conventions that will be available.

There are a number of ways a risk-free rate such as SOFR differs from LIBOR, including immature supporting infrastructure, a lack of liquidity, the absence of a term structure, and the absence of the implied credit premium. It's also important for market participants to familiarize themselves with the spectrum of SOFR variants to which they will have access, from a daily RFR published by the Federal Reserve to simple and compounded RFRs 'in arrears' and 'in advance.'

According to a July 2020 ARRC release, 'in arrears' refers to the calculation of interest using daily SOFR rates published during the relevant interest periods unlike forward-looking term rates, which are set 'in advance' and fixed during each interest period.

The **'in arrears' variant has a lower price point** because the SOFR rate in part carries additional basis risk for the Banks.

Assuming SOFR and LIBOR are value neutral, what SOFR variant would you be most willing to enter into?

Source: The sun sets on LIBOR, 2021

The 'in arrears' variant has a lower price point because the SOFR rate in part carries additional basis risk for the Banks. Yet 'in advance' is a more convenient product for corporations replicating the operational characteristics of LIBOR making it easier for corporations to manage cashflow, ensure their systems conform, and do general accounting work.

Many corporate borrowers across multiple industries don't want to use the 'in arrears' variant of SOFR primarily because it's often difficult to implement operationally. Additionally, because the company doesn't immediately know the applicable payment amount, there can be issues around financial planning, liquidity, and other key business activities. It's often unsuitable for many companies' business model.

However, it's important to note while companies may want to use the 'in advance' version of SOFR, it simply may not always be available from their lender.

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Action steps toward operational readiness

Although non-financial companies should have a plan in place to ensure operational continuity for LIBOR's cessation at the end of this year, clearly many organizations have not yet initiated a transition strategy. Certainly, COVID-19 has complicated matters, but the potential legal, regulatory and financial risks of not getting out in front of the transition are varied and serious.

While preparing to transition away from LIBOR requires substantial effort across the organization, exposure analysis and operational readiness are the most demanding of all. The operational factors that must be considered are extensive in relation to the number of clients, products, systems and legal jurisdictions involved.

We suggest the following action steps:

1. Identify existing LIBOR-based instruments or contracts.
2. Perform an impact assessment of the transition to SOFR and determine necessary mitigation actions.
3. Reach out to banks to devise a timely and efficient LIBOR-to-SOFR conversion strategy for current LIBOR-based instruments or contracts.
4. Review intercompany lending and treasury investments/ securities impacts.
5. Understand SOFR alternatives and which conventions align best with your commercial strategy.
6. Assess your financial operations to determine how SOFR-based interest calculations might impact cash flows.
7. Evaluate financial models and systems and work with third parties, as needed, to apply alternate rate replacement updates.
8. Analyze how SOFR-based products may perform relative to LIBOR-based products under different market conditions.
9. Prepare your approach for communicating with your lender(s).

The **operational factors** that **must be considered** are extensive in relation to the number of clients, products, systems and legal jurisdictions involved.

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KPMG can help

The transition away from LIBOR requires experienced, cross-functional knowledge to effectively navigate the many implications with minimal disruption — from accounting and financial management issues to risk and regulatory compliance.

Our professionals are available to support your migration to a new benchmark across all pertinent dimensions, including:

Transition strategy planning and implementation

End-to-end impact assessment

Technology and data systems analysis

Client and internal communication

Governance and ongoing monitoring

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