KPMG

# Evolving LIBOR

## Planning the transition to new Risk Free Rates

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# Introduction

Almost a year after the Financial Conduct Authority's (FCA) Chief Executive Andrew Bailey announced[1] that the FCA would no longer compel banks to submit data to the London Interbank Offered Rate (LIBOR) after 2021, there is now a clear global direction of travel towards alternative risk free rate benchmarks (RFRs) based on transactional data.

Firms must take action now to plan for this very significant structural shift. However with so many of the details of the transition remaining uncertain, including timing and jurisdictional differences, firms will require a flexible cross-functional programme to adapt to changes in the global landscape.

Transactional RFRs offer some advantages over interbank offered rates (IBORs). They are based on executed transactions, which removes expert judgement from the submission process and reduces the direct conduct risk. The underlying overnight markets also contain greater liquidity and transaction volumes than most IBOR tenors.

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor



Nevertheless, moving from IBORs to these new RFRs will not be straightforward or without risk:

- Replacing IBORs with new RFRs may improve public perceptions surrounding the rate setting process, but the system will still rely on one type of benchmark. The new RFRs are still likely to have significant leveraged exposure.
- Uncertainties remain about the practicalities of transition – including whether IBORs will remain in existence post 2021 and how and when robust term reference rates based on RFRs will be created.
- RFRs and any new term rates may still be susceptible to indirect manipulation depending on their methodologies, market and liquidity conditions.
- Transition risk is high given the value and volume of the contracts, the range and complexity of products, and uncertainty over timings and final approaches by region.
- The cost and scale of transition for firms affected is likely to be significant while other risks, for example conduct risk, will also require careful consideration.

Operating within these challenges, it is important for firms to be nimble and create optionality within their planning. Firms will need to have a proactive understanding of their underlying portfolio of IBOR products and their client's positions. There are a number of different scenarios which could play out over the next few years and firms will need to be adaptable.

# Implications for firms

All firms must now proceed with their transition planning or risk leaving it too late to mobilise. Making the transition from IBORs to the alternative RFRs will be a large-scale, front-to-back process that could take place over several years. The work involved is substantial and challenging.

Given the continuing uncertainties over both substance and timetables, firms will need to be nimble and create optionality within their planning. They should begin to position themselves through dynamic and early-stage planning, while maintaining the agility to manage a spectrum of potential transition options – a series of "no regret" actions.

While the outlook is uncertain, it is now possible to move forward with careful scenario planning, without ruling out options and flexibilities that could prove valuable once the detail of transition to the alternative RFRs comes into focus. The three broad scenarios listed in this paper can provide firms with a practical base for planning for both the short and medium term.

Firms that engage with planning at the earliest possible opportunity will secure crucial advantage in making the transition both effective and efficient. It is critical that the end users and customers are at the forefront of a firm's planning and that firms do not lose sight of this in the complexities of technical implementation.

The transition to the new RFRs will involve potential operational, legal and conduct risks. Firms who understand their exposure to IBORs, have commenced client outreach and have a flexible programme will be best positioned for all potential scenarios.

Firms will need to develop proactively their understanding of their underlying IBOR exposures (derivative and cash products together with finance processes) – both their product sets and the maturities of their contracts – and the counterparties and customers with which they have contracts or transactions in place.



## In practice, transition planning will require a series of activities:

**Contract identification –** of 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, however other cash products (for example FRNs) typically have less normalised contracts and can have additional legal jurisdiction complexities to be resolved.

**Client outreach** – clear and early communication is needed with customers to provide education and information, and to pave the way for renegotiation of contracts and collaborative case management to minimise any financial value transfer.

**Initial impact assessment** – encompassing 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 customers. Global organisations have the additional complexity of needing to consider regional transitions and timings.

**RFR programme setup –** development and management of an organisational, 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.

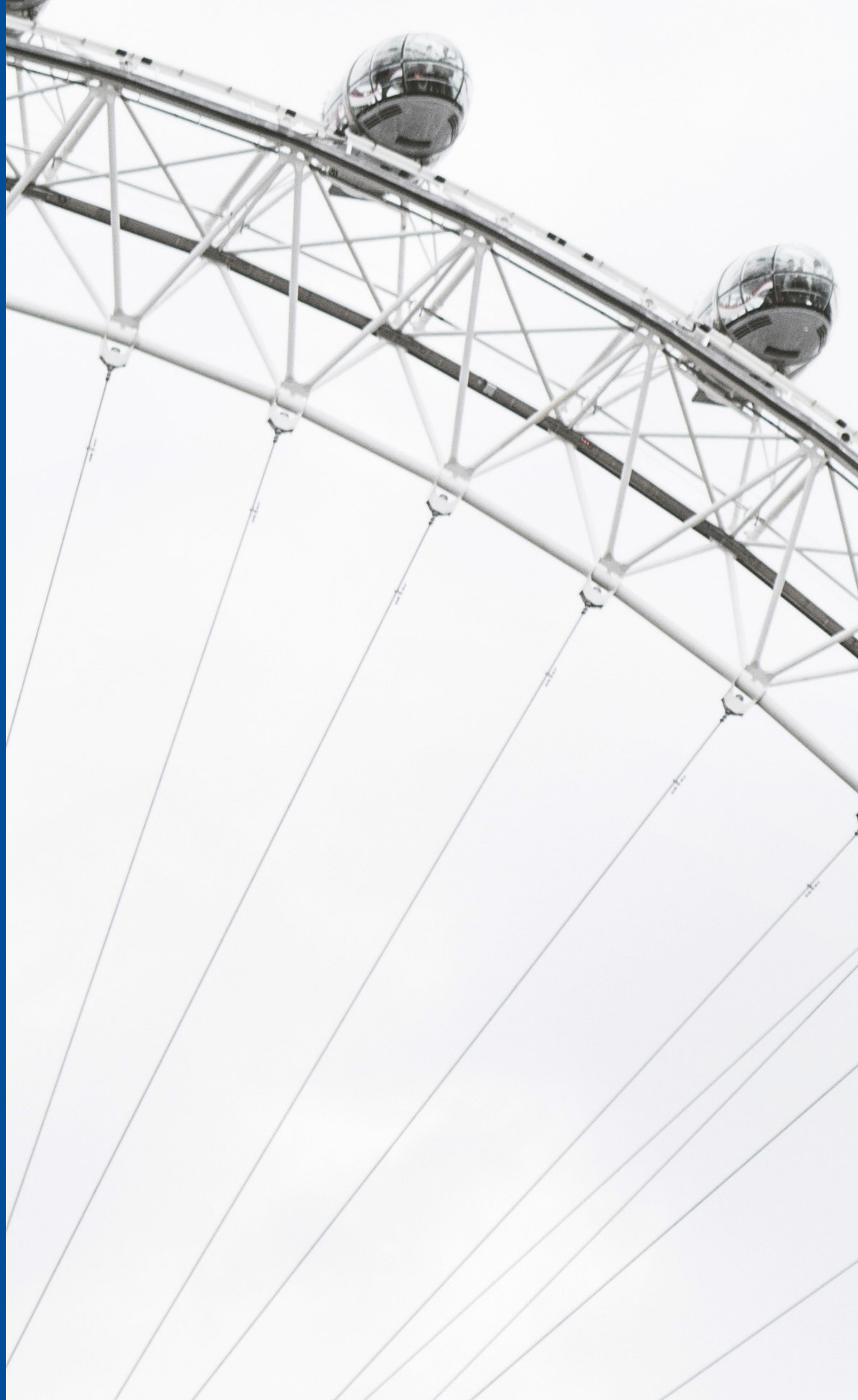
**Speciality focus areas** – specific focus will have to be applied to technical areas such as accountancy and tax impacts (in particular cashflow hedging and transfer pricing). There are potentially large profit and loss impacts resulting from hedge treatments at the transition. Again as an industry these need to be worked through and may require clear signalling to the market.

**Governance and education –** organisations will need to develop internal governance processes to approve changes to policies, systems, processes and controls. It will be imperative that firms ensure customers are being treated fairly through the transition. Firms will need to educate employees on the transition implications so they can guide clients transparently and fairly through the process.

# Planning for potential transition scenarios

Dynamic planning begins with scoping out the potential scenarios for change. In the US, the Alternative Reference Rate Committee (ARRC) has indicated[2] that it is planning to create a term reference rate based on SOFR by the end of 2021. The ARRC has documented a paced transition plan with anticipated milestones for USD LIBOR, however other jurisdictions appear to be less advanced. While the detail of transition approach and timing may not yet be fully fleshed out, it is nonetheless possible to envisage how the process might develop, given what is already known.

We consider three possible broad scenarios here. They are illustrative rather than definitive, but provide a basis for transition planning that enables firms to move forward while leaving their options open. All three scenarios assume LIBOR exposure will continue to grow during 2018, while fall-backs are analysed and better understood, with the liquidity of alternative RFRs developing and building during 2019 and beyond.



[2] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report

# Scenario 1

## The big bang

Some market participants would prefer a "big bang" approach to transition, in which the switch from IBORs to the new RFRs takes place at a defined point in time, agreed as part of a structured legal and regulatory framework.

Advocates of this approach argue that it would provide greater certainty about the transition outcome timings, reduce legal and conduct risk, and eliminate the need for continued reliance on IBORs after a defined date.

However, a big bang transition will be challenging given the scale of work and co-ordination required between regulators, market participants and trade bodies.

In our view, while this scenario remains a possibility, it is less likely unless regulatory attitudes towards a fixed point of transition harden and are supported by statutory reforms.

# Scenario 2

## Proactive market adoption

In this scenario, the adoption of new RFRs would be accelerated, even without regulatory intervention, as participants make a determined effort to renegotiate contracts with their clients in bulk and on a bilateral basis. The forward looking book would move to RFRs.

This scenario is similar to that envisaged under the ARRC paced transition plan for SOFR and may become the preferred route for other jurisdictions. The ARRC plan is intended to progressively build the liquidity required to support the issuance of, and transition to, contracts referencing SOFR. It aims to create conditions in which a robust term reference rate based on derivatives referencing SOFR could be constructed, and itself used in some cash products.

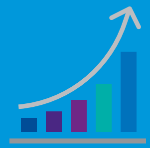
One advantage of moving in this way is that the new benchmarks would benefit from self-fulfilling liquidity, automatically accelerating the decline in reliance on IBORs. While an enforced transition of rump contracts might still be required at a fixed point in time, this would be a less dramatic shift than the big bang in Scenario 1, involving fewer contracts and potentially occurring earlier.

Given the recent launch of CME futures for SOFR in 1 and 3 month tenures, and open interest in contracts forming for maturities beyond 2021 highlights the market is beginning to adopt SOFR in the short term.[3]

Nevertheless, scenario 2 would still be a challenging prospect. It would require significant co-operation and sequencing between large numbers of market participants based in different regions and operating different product types.

[3] http://www.cmegroup.com/trading/interest-rates/stir/three-month-sofr.html

# Scenario 3



## A steady multi-year transition

This scenario envisages a slower build-up of exposures to the new RFRs, while short-dated LIBOR positions run off – over four to five years, for example. The new RFRs would be used as old positions mature and roll over.

This would mean that LIBOR continues, at least in some form, beyond 2021 as a natural run-off takes place. Exposures to the new RFRs would grow over time and might be combined with the introduction of a synthetic version of IBORs (the FCA has discussed this possibility) to allow run-off without frustration of contract.

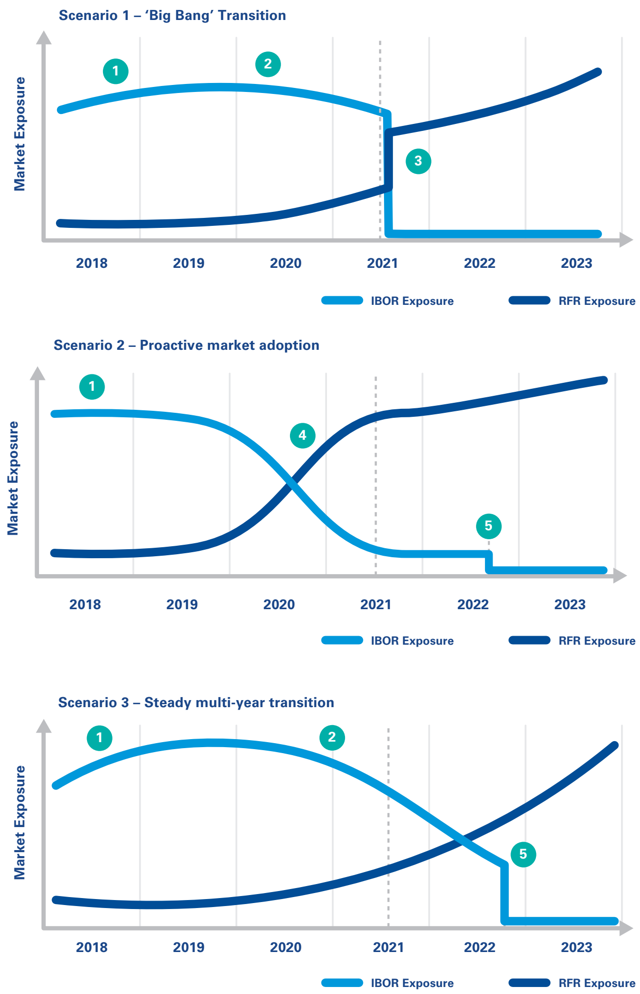
The rump of IBOR legacy contracts would be smaller in volume (reducing disruption and conduct risk) and primarily in long dated products. The transition to the new RFRs would be at a rate plus a prevailing spread at the time. It would be important for firms to choose an appropriate date for this rump transition, given that IBOR liquidity will diminish over time.

Scenario 3 may be appealing in its avoidance of a big bang moment or a definitive early deadline. However, the risk of this approach is that momentum and liquidity are compromised, resulting in the status quo prevailing or the market shifting in a dislocated manner with undesirable volatility or liquidity characteristics.

All three of these potential scenarios assume that the new RFRs develop liquidity across a range of products that satisfy the demands of a broad user base.

The scenarios are likely to vary by jurisdiction, though the concepts will be broadly similar. On balance Scenario 2 appears to provide the best outcome for the market. The ARRC currently has the clearest public timetable for the transition to RFRs and we anticipate other jurisdictions will follow in short order. The market exposures and evolution of each of these scenarios is illustrated in Figure 1.

## Figure 1: Transition scenarios in practice




### Key to charts

1. LIBOR trading as normal (therefore exposure growing as normal) until RFR is confirmed, trading and liquidity is growing sufficiently in relevant products to support end user requirements, and arrangements for fallback are better documented and understood.

2. Slow build-up of positions in new RFR products, short dated LIBOR positions run off, e.g. where old positions mature and are rolled, new RFRs are utilised.

3. LIBOR discontinued 'big bang' style at the end of 2021 (the time at which FCA has compelled submitters to continue contributing IBOR). At this stage 'big bang' appears challenging not only due to the size of the task of achieving enough coordination but also while LIBOR is at risk from that point in time in terms of contributions, it's not likely to be 'switched off'. This scenario may become more likely if regulatory (and/or statutory) attitude hardens toward a fixed switch over.

4. Scenario 2 is based on accelerated market adoption of RFR and a push to renegotiate contracts on a bulk bilateral basis. This will have the advantage of creating self fulfilling liquidity in the new products, accelerating the decline in reliance on LIBOR. This, however, requires significant coordination among market participants which will be challenging.

5. Rump of LIBOR (e.g. say 20% of legacy contracts) transition to RFR (presumably RFR plus a prevailing spread at the time the rump is transitioned). Scenario 2 has smaller exposure than 3 for the rump transition. The advantage is that there would be a smaller volume and (potentially) less transition disruption, with a focus on specific pockets of trades e.g. likely to be long dated products. One major issue is choosing when this could occur and the trade off with diminishing liquidity in the legacy products. [In Scenario 2, this rump is likely to be significantly smaller or occur earlier] Alternatively the rump remains on a synthetic LIBOR basis.

Note this analysis is carried out based on the UK – specifically the 2021 date specified by the FCA. Timelines will vary according to jurisdiction, however the transition concepts should be similar.

# The scale of the challenge

There is no doubting the significance of the shift away from IBORs. These benchmarks have been employed globally in products and services used by retail, corporate and wholesale banks, as well as market players including insurers, pension funds, clearing houses and corporates for over 30 years.

Moreover, the volumes at stake are enormous. The Financial Stability Board estimated that in 2014[4] more than $370 trillion worth of notional contracts used LIBOR, EURIBOR or TIBOR as a reference rate. Some $190 trillion of these exposures were in IBOR derivatives.

The benchmarks are embedded in a very wide range of products, including loans and mortgages, floating-rate notes, securitisations, derivatives and deposits. Retail exposure, in certain markets, is significant, with estimates suggesting more than 10 million individual customers have products that make use of IBORs.

IBORs are not only used as a reference rate for financial products. The benchmarks are also important for purposes such as discounting calculations in pensions, tax, insurance and leasing as well as being embedded in finance processes such as remuneration plans and budgeting tools.

The bottom line is that IBORs are firmly entrenched in financial markets at a global level. The interconnected nature of these benchmarks and markets makes it imperative for financial stability and confidence that the transition to alternative RFRs is managed carefully and smoothly. Yet very significant questions remain. To allow a more detailed transition plan to develop:

- There are potentially significant regional differences and approaches to the transition. The ARRC 'paced transition plan' for LIBOR USD to SOFR has an outlined path; the Bank of England started its administration of unsecured reformed SONIA in April 2018; the Swiss transferred from TOIS to SARON in December 2017 and are working on a plan for CHF LIBOR; while the ECB has only recently convened its working group. At the moment there is indicative support for EURIBOR continuing in a modified guise. As a result organisations have to manage multiple timelines.
- The liquidity required to support the hedging and risk management relating to the new RFRs is still to be fully developed. The ARRC has noted that creating a robust demand for the new RFRs is key to ensuring a smooth transition;
- The new RFRs are overnight indices and currently have no term structure (unlike IBORs). The emerging consensus across the market is that term rates will be required, at the very least for cash products (where users see benefits in knowing their future cashflows), but also to support and ease the

[4] http://www.fsb.org/wp-content/uploads/r_140722.pdf

transition process. The ARRC has indicated a term structure is likely to be preferable for SOFR, though its target date for creation is not until 2021, which looks late against a potential LIBOR end date;

– There are material challenges to develop liquidity in new products and to manage the existing book of financial contracts, but this work is at an early stage. For example, through its work on fall-backs, the International Swaps and Derivatives Association (ISDA) is working through proposed approaches for how legacy contracts could fall-back to alternative RFRs should there be a permanent discontinuation in IBORs as well as amendments including credit spreads applying to fall-back RFRs and addressing term fixing issues; and

– A range of financial institutions have been engaging with regulators and trade associations to drive a potential transition. However, given the vast number and different types of users, there will be significant challenges to arrive at an approach which works for all parties.

In our view, firms that engage with planning at the earliest possible opportunity will secure crucial advantage in making the transition both effective and efficient. It is critical the end users and customers are at the forefront of organisation's planning and firms don't lose sight of this in the complexities of technical implementation. While the outlook is uncertain, it is now possible to move forward with careful scenario planning – and to do so without ruling out options and flexibilities that could prove valuable once the detail of transition to the new RFRs comes into focus.

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