Drilling Down

Navigating the LIBOR transition (part 1)

The London Interbank Offered Rate (LIBOR) has been a major benchmark interest rate for decades, underpinning hundreds of trillions of notional volume in debt instruments and derivatives. Market reform has been in the works since 2012's *Wheatley Review*,[1] and a major transition is expected based on those ongoing efforts.

In July 2017, the U.K.'s Financial Conduct Authority (FCA) announced that it would not compel or persuade panel banks to make LIBOR submissions after the end of 2021. The result has been a flurry of activity as market participants began choosing alternative reference rates and developing practical roadmaps for transitioning from LIBOR to new reference rates.

Given that the permanent discontinuation of LIBOR seems likely, firms with floating rate debt, derivatives, or any other LIBOR exposures must develop a transition plan and take measures to minimize the transition's financial and operational impact on the business. Debt and swap pricing, hedging costs, valuations, and internal financial models are all examples of areas impacted by the transition to alternative reference rates. In addition, oil and gas companies can expect to see impacts to intercompany lending, late payment provisions in commercial contracts, structured financing transactions, and other LIBOR-referencing contracts outside of their normal banking agreements.

To address this complex challenge in more detail, we have asked KPMG's Eamonn Maguire and Brian O'Neal to discuss how firms can navigate the uncertainties of LIBOR transition.

Come 2021, what do you expect the situation to be with regard to LIBOR?

At this point, borrowers can assume that LIBOR is going away. What is less certain is the speed with which the market embraces newer rates—such as the Secured Overnight Financing Rate (SOFR) in the U.S. and Sterling Overnight Interbank Average rate (SONIA) in the U.K.—and the development of those markets' liquidity and term structure over time. What is even less certain is the full extent to which a reference rate transition will affect normal business operations beyond debt issuance and derivatives.

This uncertainty should not delay firms' decisions to proactively create contingency plans based upon multiple scenarios, the most important of which is the likelihood of a shift to nearly risk-free rates (RFRs). We currently see ongoing regulatory pressure for change in multiple jurisdictions and now expect that future debt and derivative activity will result in RFR-based markets. Firms that take steps today should be able to significantly reduce the overall cost, event risk, and overall risk profile of their transition from IBORs to RFRs.

How do RFRs differ from LIBOR?

The exchange is not nearly as simple as replacing one reference rate with another. RFRs differ fundamentally from LIBOR rates in at least six significant areas:

1. **Undeveloped infrastructure:** RFRs will require an entirely new infrastructure. While fintech firms and market participants are developing infrastructure and supporting technology tools necessary to support the RFRs, they will roll out over time and may not be available or mature at launch.
2. **Liquidity scarcity:** Liquidity supporting RFR transactions will require the development of sufficient two-way markets. Additionally, corporations should monitor the LIBOR market that may be phasing out to ensure sufficient liquidity to sustain hedges or exit LIBOR transactions via sale or buy-back.
3. **Term structure absence:** While some RFRs, such as SOFR, are scheduled to offer a term structure, none currently exist across all RFRs. Corporations should be aware of the pitfalls and challenges that could emerge.
4. **Credit adjustment inclusions:** LIBOR carries an implied credit premium, while RFRs are intended to be close to "risk free." Corporations will need to rebuild their valuation and risk models and calibrate to the credit premium eliminated by RFRs.

[1] WHM Treasury, The Wheatley Review of LIBOR: final report, September 2012. Available at: https://www.gov.uk/government/publications/the-wheatley-review

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5. **Volatility impacts:** As market-driven rates, RFRs should provide a trusted and empirical source, but they may carry increased volatility vis-à-vis LIBOR. As of June 2018, overnight RFRs have in fact displayed higher volatility than LIBOR. A corporation that relies on options-based hedging strategies should evaluate a potential increase in its cost of hedging.
6. **Basis risk:** During the transition from LIBOR to RFRs, synthetic and natural hedges may erode and cause higher basis risk. As a result, hedging cash products or managing ALM programs could become more complex without a deep basis swap market capable of aligning the underlying to the hedge. Corporations need to monitor and manage emerging basis risk as assets transition to RFRs and sources of bank funding may continue to stay linked to LIBOR rates. Credit, liquidity, volatility, and term structure differentials could all generate additional basis risk.

While the market ultimately prefers a forward-looking term for SOFR at tenors that track the structure of LIBOR and a variety of financial instruments, oil and gas companies should familiarize themselves with the potential SOFR variants currently in play today. These include Simple Daily, Simple Daily Average, SOFR-in-Advance (referencing the prior 30 days to calculate payment due at the end of the next 30-day period), and SOFR-in-Arrears (compounding prior-day rates at the end of the pricing period).

SOFR-in-Arrears is currently gaining traction as the preferred methodology in derivatives' markets by more than 70 percent of ISDA participants. As applied to cash-based products, and in particular commercial lending, SOFR-in-Arrears means that payment applicable for the period would not be known until the end of the payment period. For example, in a 30-day payment period, SOFR daily rates would be compounded until the end of the period and the applicable interest rate payment calculated for that period. Consequently, corporations would not know the applicable payment amount, thereby creating issues for financial planning, available cash, and other key activities. On the lending side, it would necessitate significant changes to loan operations and potentially affect credit risk evaluation and underwriting activities to qualify the corporate borrower.

In the next issue, we will consider steps corporations should take to prepare for the coming transition.

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