End of an IBOR era

Key transition challenges for the financial services industry
After more than 40 years of the financial services industry relying on interbank offered rates (IBORs) as a reference rate for variable-rate financial instruments, the London Inter-Bank Offered Rate (LIBOR) and other IBORs are being replaced by alternate reference rates (ARR). LIBOR, which started its life in 1969 as a reference rate for a syndicated loan transaction, today underpins more than $300 trillion of financial contracts. IBORs also serve as a benchmark rate for performance measurement for investment securities and as a proxy rate for wholesale funding rates. Since 2012, LIBOR has been mired in scandal and gained negative public attention when several global banks were accused of manipulating their IBOR submissions during the financial crisis. Since then, global regulators have taken several steps to strengthen the IBOR (often referred to as IBOR+), including appointment of a new benchmark administrator, ICE Benchmark Administration. However, IBORs are no longer deemed to be a desirable benchmark due to very low transaction volumes in the unsecured wholesale funding markets that underpin the IBOR submission. For example, 3-month USD LIBOR, the most heavily referenced LIBOR, is supported by less than $1 billion in transactions per day.

In the US, the Alternate Reference Rate Committee (ARRC), convened by the Federal Reserve, recommended the Secured Overnight Financing Rate (SOFR) as the most suitable to be used for US dollar derivatives and other financial contracts. SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. It is a fully transaction-based rate incorporating data from transactions across three segments of the U.S. Treasury Repo market (tri-party repo, General Collateral Finance (GCF) repo and bilateral repo cleared through the Fixed Income Clearing Corporation (FICC)).

SOFR was first published on April 3, 2018, at 1.80% based on a volume of $800 billion of repo transactions as of April 2, 2018. Each business day, the Federal Reserve Bank of New York (FRBNY) publishes the SOFR at approximately 8:00 a.m.

The transition from USD LIBOR to SOFR is expected to be a significant transformation effort for financial services firms and market participants that have extensive exposure to LIBOR-linked products and contracts. In addition, IBORs are also extensively embedded within the processes, operations, models, data and technology infrastructure at financial services firms. For example, LIBOR is commonly used as a future cash flow discount factor for valuation of financial instruments.
EY has identified the top 10 challenges that banking and capital markets organizations and other financial market participants will face in transition to the alternate reference rates.

1. **Client outreach, repapering and negotiating contracts.**
   
   For any contract maturing beyond 2021, firms may need to renegotiate with their borrowers and counterparties to transition the base rate from USD LIBOR to SOFR. Unlike derivatives contracts, which will be addressed in bulk through updates to standard contract language (protocol), cash products for corporate and retail end users have limited contract standardization, or industry protocol. Moreover, the inventory of contracts and terms may not be easily searchable within firms’ systems. Firms will need to identify the affected contracts, digitize them, extract the relevant terms, educate counterparties as to the need for repapering and update each contract through bilateral or multilateral negotiations. In addition, for contracts maturing before 2021, firms will need to update the fallback language in the existing contracts to address the potential risk of LIBOR discontinuation before 2021.

2. **High litigation, reputation and conduct risk.**
   
   The change in base rate from USD LIBOR to SOFR will also require renegotiating the spread due to the inherent differences between LIBOR and SOFR (i.e., credit and term premium). For example, if a bank comes up with its own approach for redefining the spread for its variable-rate instruments, their customers and counterparties may respond to unfavorable outcomes relative to the prior benchmark by initiating a legal action (value transfer). Alternatively, if several banks collaborate as an industry to set a new standard spread for variable-rate products, they may be accused of price-fixing under antitrust law. Either way, the bank may face increased legal risk with reputational impact.

Based on the paced transition plan, ARRC members (dealers) are expected to put in place infrastructure for trading in SOFR futures and/or overnight index swap (OIS) trading in SOFR in the second half of 2018. In addition, CME Group Inc. has planned to launch monthly and quarterly SOFR futures on May 7, 2018. Market adoption and liquidity in SOFR derivatives will be a key success factor for the paced transition plan. As the transition timing for cash products to SOFR is uncertain, the demand for SOFR derivatives to hedge potential interest rate risk embedded in cash products will likely be missing (for example, a borrower that wants to hedge a floating interest rate loan based on SOFR), as SOFR does not currently qualify as an eligible benchmark rate for hedge accounting.


IBOR rates are available for terms ranging from overnight to 1 week to 12 months, which allow corporate and retail clients to borrow using variable-rate instruments with certainty of cash flow (interest payments) throughout the term. SOFR, initially, will solely be an overnight rate, which means that term rates will likely need to be calibrated based on transactions in the SOFR futures market. The definition of term rates is scheduled for 2021, which may need to be reconsidered to facilitate the transition of cash products to ARR. Further, given the inter-relationship between the cash and derivatives markets (e.g., for hedging), the development and transition work for SOFR and term rates needs to run concurrently.

5. Differences in ARR and transition timelines across G5 currencies.

While the US market has settled on the SOFR rate, the UK will use the Sterling Overnight Index Average (SONIA), which is an unsecured rate. This movement away from an international unsecured standard (LIBOR) may result in challenges in cross-currency swap markets. Instead of using the similar rate for both legs of a foreign currency (FX) swap, trades may need different rates for each leg (e.g., USD at secured SOFR swapped for GBP at unsecured SONIA). Further, the lack of harmonization in transition timing to alternate reference rates or in the timing of publication of daily ARR's across G5 currencies may result in additional challenges for the FX swap markets.

6. Regulatory uncertainty.

Regulatory mandates tend to arrive with clear guidance, legal certainty and prudential incentives for rapid compliance. Yet regulators see the IBOR transition not as a mandate, but rather as a voluntary, industry-led initiative. This perspective may cause delays as the industry uncovers situations requiring regulatory guidance or legal rulings. The lack of definitive regulatory guidance on the IBOR transition may slow down progress as banks deem “wait and watch” as the prudent strategy, which may further aggravate the situation due to a buildup of more legacy contracts inventory for future transition.

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1The Financial Accounting Standards Board (FASB) has released an exposure draft for comment on Derivatives and Hedging (Topic B15) “Inclusion of the Overnight Index Swap (OIS) Rate Based on the Secured Overnight Financing Rate (SOFR) as a Benchmark Interest Rate for Hedge Accounting Purposes”
Operations and technology changes.
Over the years, IBOR has been extensively embedded in business and operational processes, from low-level data structures to applications built over decades. The transition away from IBOR will require significant changes, made more difficult given the lack of certainty as to the timing and desired target state. At the very minimum, firms will need to identify every reference to an IBOR across the entire organization, and then replace it with a pointer to one of several possible reference rates, with the choice contingent on the specific situation.

Accounting considerations.
The Financial Accounting Standards Board (FASB) recently issued guidance on derivative and hedging transactions in ASC 815, and there are proposed amendments to ASC 815 that will add SOFR as a benchmark. Banks will need to ensure that, as they replace IBORs with bundles of financial instruments (which may include SOFR derivatives plus interest-rate derivatives), the bundles qualify and are recognized as eligible hedges under the accounting rules.

LIBOR may yet survive.
The announcements by the Financial Conduct Authority (FCA) regarding the future of LIBOR highlighted the risk that LIBOR may cease publication at some point after 2021. However, the most recent speech by Andrew Bailey, chief executive of the UK’s FCA, hinted at a potential use of synthetic LIBOR for existing contracts beyond 2021. In addition, most recently, the ICE Benchmark Administration has hinted at the possibility of LIBOR being kept alive for selected currencies and tenors beyond 2021, derived based on a spread over the alternate reference rates (e.g., LIBOR after 2021 = SOFR + x%). The lack of clarity on the future of LIBOR is a key hurdle in the mobilization of transition activities related to existing contracts maturing beyond 2021. Further, the survival of LIBOR beyond 2021 may result in the fragmentation of liquidity in the derivatives markets and potentially an increase in basis risk for banks.

Valuation, model and risk management.
IBORs have long been a convenient proxy for general interest rate risk used in valuation and risk modeling, and as a discount factor for prepayment schedules and other situations in financial modeling. As such, a wide range of financial and risk models will need to be redeveloped, recalibrated and revalidated using ARR. The lack of availability of historical time series data on ARR is likely to be an issue for risk modeling. Firms will need to quickly build an inventory of all pricing, valuation and risk models that have a dependency on IBORs and rank order the models based on materiality and complexity for redevelopment. Further, asymmetry in the timing of transition across different products and linked contracts may result in additional basis risk for firms.
The extensive use of LIBOR in financial markets across a range of products, contracts and business processes will likely make the transition to alternate reference rates an enterprise-wide transformation initiative. Although 2021 may seem far away, banks need to mobilize their transition efforts urgently and elevate this topic within their organization.

Given the uncertainty, it is important to comprehensively assess the issues across the 10 areas summarized above. The assessment will allow firms to size the challenges facing their organizations and the potential resource requirements and effort to address them. This will provide the information necessary to inform executive management and the Board on the probable impact and how the firm is likely to address it.

The financial services industry has an important role to play in educating end users of financial products on the looming risks of ongoing dependency on LIBOR and guide them through this transition process. Firms that proactively engage with their customers, and offer new products linked to ARR, are likely to be at a competitive advantage.

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