2019 to 2021: LIBOR Transition

November 2019
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Overview

Global regulators have signalled that firms should shift away from using the London Inter-bank Offered Rate (LIBOR) and switch to alternative overnight risk-free rates (RFRs).

This is important because LIBOR underpins contracts affecting banks, asset managers, insurers and corporates, with estimated exposures totalling USD 350 trillion globally on a gross notional basis. This figure underscores the extent to which market participants rely on LIBOR and the market disruption that its sudden and disorderly discontinuation could cause.

Standard Chartered has responded to this situation by launching a LIBOR transition programme to help the bank and our clients to navigate the many challenges resulting from the transition.

This introductory brochure provides a brief summary of LIBOR's background and the pending changes, as well as highlighting some key points to consider as part of the transition.

What is LIBOR?

LIBOR is arguably the most important Inter-bank Offered Rate (IBOR) used in the global financial markets. It serves as a key interest rate benchmark across a number of financial products including derivatives, securities, loans and mortgages.

LIBOR provides an indication of the average rate at which each LIBOR contributing bank can borrow unsecured funds in the London interbank market for a given period, in a given currency. It is calculated and published daily across five currencies (GBP, USD, EUR, JPY and CHF) and seven maturities (overnight, one week, and 1, 2, 3, 6 and 12 months) by the ICE Benchmark Administration. It is based on submissions by a panel of banks using available transaction data and their expert judgement.

“The discontinuation of LIBOR should not be considered a remote probability ‘black swan’ event. Firms should treat it as something that will happen and which they must be prepared for. Ensuring that the transition from LIBOR to alternative interest rate benchmarks is orderly will contribute to financial stability. Misplaced confidence in LIBOR’s survival will do the opposite.”

– Andrew Bailey
Chief Executive
Financial Conduct Authority (FCA)
July 2018

Source:

https://www.risk.net/derivatives/6004331/the-350-trillion-problem-too-big-to-solve
Why is reform required?

Post the financial crisis, changes to bank capital requirements resulted in a significant decrease in transaction volumes in the unsecured inter-bank lending market - upon which LIBOR is based. With insufficient transaction data, LIBOR submissions have increasingly relied on expert judgement from the panel banks. Regulators have therefore grown increasingly concerned about the long-term sustainability of the benchmark and have decided to pre-empt any further possible deterioration by indicating their preference of an end to LIBOR.

It is not only regulators that are concerned. Panel banks have expressed discomfort about providing submissions “based on judgements with little actual borrowing activity against which to validate their judgements” and as a result, the Financial Conduct Authority (FCA) has “spent a lot of time persuading panel banks to continue submitting to LIBOR.”

In the UK, the FCA has stated there is wide support from the panel banks to sustain LIBOR for the period up to the end of 2021 on a voluntary basis. This means that LIBOR will remain as a benchmark with any certainty only until the end of 2021.

“Since the financial crisis, LIBOR really has become the rate at which banks don’t lend to each other.”

– Mark Carney
Governor, Bank of England
May 2018


LIBOR has been in the news for many years. The timeline of events below highlights some of the notable milestones leading up to the LIBOR transition.

<table>
<thead>
<tr>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2017</th>
<th>2018</th>
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<tr>
<td>UK Government Wheatley Review recommends “Reform not Replace”</td>
<td>February: O2O commissioned FSB review “Reforming Major Interest Rate Benchmarks”</td>
<td>February: ICE Benchmark Administration became the administrator of LIBOR</td>
<td>July: Andrew Bailey, FCA announced no longer encourage panel banks to submit post 2021</td>
<td>July: FCA announced markets need to end their reliance post 2021</td>
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<td>April: Public consultation on “IOSCO Benchmark Principles”</td>
<td>March: Final report of the Market Participants Group on Reforming Interest Rate Benchmarks</td>
<td>July: Review of the implementation of IOSCO’s Principles for Financial Benchmarks by Administrators of Euribor, Libor and Tibor</td>
<td>September: Dear CEO letter jointly issued by FCA and PRA to 15 market participants</td>
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What is the alternative?

Since 2014, a number of jurisdictions have set up working groups to identify alternative risk-free rates (RFRs) to LIBOR. This was as part of a G20 initiative, delegated to the Financial Stability Board (FSB), to review and reform critical benchmark rates. The FSB established an Official Sector Steering Group (OSSG) to focus its work on the most fundamental interest rate benchmarks. The working groups focussed on identifying rates that had markets of suitable size underpinning them and a robust governance framework for their calculation. Some of these rates were already in existence while others had to be created.

Whilst alternative RFRs for each of the LIBOR currencies have now been identified, the different jurisdictions are at varying stages of progress. In particular, the depth and liquidity of the market differs across the respective RFRs and product set (e.g. derivatives, bonds and loans).

The alternative RFRs are considered more robust and reliable interest rate benchmarks than LIBOR as their calculation is based on actual transactions in the underlying market. For example, while USD LIBOR has a daily average of USD 1 billion of underlying transactions, the chosen replacement, the Secured Overnight Financing Rate (SOFR), is underpinned by daily transactions of approximately USD 700 billion. Being based on actual transactions, instead submissions using expert judgement, makes the RFRs more representative of the true cost of funding in the underlying markets.

Table 1: Alternative RFRs by jurisdiction

<table>
<thead>
<tr>
<th>Currency</th>
<th>$USD</th>
<th>£GBP</th>
<th>¥JPY</th>
<th>CHF</th>
<th>€EUR</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Alternative RFR</strong></td>
<td>Secured Overnight Financing Rate (SOFR)</td>
<td>Reformed Sterling Overnight Index Average (SONIA)</td>
<td>Tokyo Overnight Average Rate (TONA)</td>
<td>Swiss Average Rate Overnight (SARON)</td>
<td>Euro Short-Term Rate (€STR)</td>
</tr>
<tr>
<td><strong>Administrator</strong></td>
<td>Federal Reserve Bank of NY</td>
<td>Bank of England</td>
<td>Bank of Japan</td>
<td>SIX Swiss Exchange</td>
<td>European Central Bank</td>
</tr>
<tr>
<td><strong>Rate Type</strong></td>
<td>Secured</td>
<td>Unsecured</td>
<td>Unsecured</td>
<td>Secured</td>
<td>Unsecured</td>
</tr>
<tr>
<td><strong>Rate Published</strong></td>
<td>Since 3rd April 2018</td>
<td>Since 23rd April 2018</td>
<td>Since 4th January 2017</td>
<td>Since 25th August 2009</td>
<td>Since 2nd October 2019</td>
</tr>
<tr>
<td><strong>Description of the RFR</strong></td>
<td>SOFR is secured, overnight and transaction-based encompassing multiple repo market segments.</td>
<td>SONIA is unsecured and overnight and is calculated based on daily sterling money market activity.</td>
<td>TONA is unsecured, overnight and transaction-based. It reflects the uncollateralised overnight call rate market encompassing multiple repo market segments.</td>
<td>SARON is a secured overnight rate that reflects interest paid on interbank overnight repo transactions.</td>
<td>€STR is an unsecured overnight rate that reflects overnight unsecured fixed rate deposits of euro area banks.</td>
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What does the transition roadmap look like?

There are many challenges relating to the transition from LIBOR to the RFRs. We note the following, albeit non-exhaustive, set of important activities and milestones that will support an orderly transition.

**Continued development of the RFR markets and products**

There are currently differing levels of liquidity in each of the markets for RFRs, both in comparison to each other, and versus LIBOR. Liquidity in the RFR markets is anticipated to continue building in the period to 2021, with the potential for declining liquidity in respect of LIBOR markets.

The development of RFR markets requires a number of industry activities to continue to progress, including updates to key pieces of market infrastructure, such as those related to clearing and settlement of RFR-linked trades, continuing product development across derivatives and cash products, as well as the establishment of market conventions across products. Recently the market has seen growing RFR liquidity with the raising of new debt referencing RFRs, as well as the development of the related swaps and futures markets. There has also been the first issuance of a corporate loan referencing SONIA.

Many participants, particularly in the loan markets, are also tracking closely the development of term rates based on the RFRs, with the working groups identified in Table 1 undertaking work in this area, albeit targeting different timelines and potentially adopting different approaches depending on jurisdiction.

**Finalisation of industry standard fallbacks, including spread adjustment methodologies**

Many contractual agreements that reference LIBOR do not anticipate an event such as the permanent cessation of the LIBOR benchmark, and hence, lack contractual provisions for successor benchmarks. This raises the question of how to maintain contractual continuity for those contracts that will be affected by LIBOR transition.

There is ongoing work, including recent public consultations published, by industry bodies such as the International Swaps and Derivatives Association (ISDA), the International Capital Markets Association (ICMA), the Loan Market Association (LMA) and the Alternative Reference Rate Committee (ARRC) aimed at developing legal language (known as fallback language) that can be incorporated into affected contracts to cater for this eventuality.

Another important aspect to consider is the spread adjustment methodologies captured by the fallback language. RFRs are overnight rates, which are considered nearly risk-free, whereas LIBOR is a term rate and reflects perceived bank credit risk. The issue is further complicated as some RFRs are based off secured transactions, whereas others are based off unsecured transactions. Hence, when transitioning to RFRs, a spread methodology will need to be applied to avoid value transfer.

**Development of industry wide mechanisms in support of large-scale re-papering**

Making the necessary changes to existing contracts to update for the new RFRs, including updating for fallback language, is expected to be a burdensome process. In certain markets, notably the derivative markets, work is underway to develop an approach whereby contractual parties can more easily adopt changes to contracts through signing up to an agreed protocol. The aim is to avoid the need for mass re-papering exercises of existing contracts.

However, whilst a potentially more efficient approach, this does not work for all markets, and even in derivative markets, not all contractual counterparties will wish to adopt a protocol developed by ISDA. In this case, each contract may need to be considered on a case-by-case basis for amendment.

**Resolution of identified tax and accounting issues**

Market participants have noted a number of potential accounting and tax issues that may arise as a result of the transition to RFRs, including those related to the areas of the recognition and derecognition of assets and liabilities, the measurement of assets and liabilities and hedge accounting.

In this regard, steps are currently being taken by accounting bodies to ensure that the market is consulted on the accounting issues and that potential reliefs are considered. For example, the International Accounting Standards Board (IASB) has published an exposure draft “Interest Rate Benchmark Reform (Proposed amendments to IFRS 9 and IAS 39)” that constitutes a first reaction to the potential effects the IBOR reform could have on financial reporting.
How is Standard Chartered preparing for the transition and what should clients be doing?

Standard Chartered recognises that the impact of the transition will be felt across our products, services and ultimately affect our clients and how we engage with them. Accordingly, we are actively participating in industry working groups and are continuing to stay close to all developments in this area. The bank has established a global LIBOR transition programme to consider all aspects arising from the transition and how any arising risks might be mitigated.

While there remains a number of uncertainties, Standard Chartered is recommending that clients commence performing their own assessment of their affected contracts, products and services and to continue to familiarise themselves in the developments in the transition to the RFRs. Clients may also wish to consider seeking assistance from professional advisors to better assess their potential financial, legal and accounting risks.
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