BY JUSTIN ONG

THE END OF LIBOR IN 2021

How prepared are you?

BACKGROUND

It was announced in July 2017 that the UK Financial Conduct Authority (FCA) would no longer persuade or compel banks to submit the London Interbank Offered Rate (LIBOR) by 2021, making it clear that reliance on LIBOR could no longer be assured beyond this date. LIBOR is a benchmark that is regulated and administered in the UK, but has been adapted by banks globally. Today, LIBOR is embedded in contracts involving banks, asset managers, insurers and corporates, which are estimated to be at US$350 trillion globally on a gross notional basis. The rate is so embedded in existing banking practices and relied upon by market participants, that the transition away from LIBOR will be one of the most, if not the most, challenging transformation programmes faced by the finance industry today.

2018 has seen regulators turning up the pressure by stating that firms should treat the discontinuation of LIBOR as a certainty and that progress has been relatively slow. In the UK, a joint "Dear CEO" letter from the UK Prudential Regulation Authority (PRA) and the FCA was sent to large banks and insurers in September, requiring boards to sign off on a comprehensive risk assessment of LIBOR transition in respect of their firms. Swiss regulators have also been proactive in reaching out to firms. Further afield, US regulators are holding bilateral discussions with firms, and the Bank of Canada has called on financial institutions to consider their "readiness" for benchmark reform.

WHY LEAVE LIBOR?

LIBOR is the underlying interest rate used in various financial instruments and millions of contracts around the world. For over three decades, LIBOR has been a reliable source used to determine the cost of financial products, from housing loans to corporate bonds, and even complex derivatives. LIBOR is calculated based on submissions from panel banks (usually the larger banks) at which they estimate the rate to obtain wholesale, unsecured funding for multiple tenures. In essence, it represents the average interest rate at which banks are willing to borrow from one another.

While this may seem like a relatively straightforward process, LIBOR has its limitations and flaws. LIBOR submissions are not based on actual transactions, but rather judgment calls, hence do not provide a strong representation of the actual landscape occurring in the market. This reliance on expert judgment increases susceptibility to manipulation.

The global financial crisis in 2008 was the tipping point for this deep-rooted benchmark in the financial system. When Lehman Brothers failed, banks refused to lend to each other at published LIBOR rates, illustrating just how weak a representation LIBOR was. As a result of the crisis, new requirements on banks' capital were introduced. The larger, systematically important global banks were compelled to hold larger liquidity buffers to cushion losses, altering the way banks fund themselves.

"The discontinuation of LIBOR should not be considered a remote probability 'black swan' event. Firms should treat it is [sic] 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 of the FCA

KEY DIFFERENCES BETWEEN UK LIBOR AND SONIA

UK LIBOR	SONIA
Various maturities	Overnight
Built-in credit component	Nearly credit risk-free
Forward-looking	Backward-looking
Deep liquidity (US$30 trillion worth of underlying transactions)	Relatively less liquid compared to LIBOR (US$610 billion worth of underlying transactions)

The limitations of LIBOR have made banks and regulators increasingly concerned about the future of LIBOR. As a response to these growing concerns, the industry has decided to transition away from LIBOR, in search for new reference rates.

ALTERNATIVE RATES AND ITS CHALLENGES

Working groups in each jurisdiction are identifying the most suitable risk-free rate (RFR) in the market, with plans to develop them in the near future. Some of the considerations include easing availability of sufficient and reliable underlying market data, enhancing robustness to changes in market structure, setting appropriate controls and governance, and reviewing the expected/actual market funding rates ratio of the RFR. These selected RFRs include pre-existing rates, reformed versions of pre-existing rates, and newly created rates.

However, RFRs are constructed differently to LIBOR. RFRs generally do not incorporate risk whereas LIBOR reflects perceived credit risk, therefore fixings for RFRs tend to be lower. This could mean that a trade which transitions from LIBOR to a RFR could have a different market value over time. In other words, there might be 'winners and losers' in an RFR transaction. Hence, valuation methodologies should be revised. Liquidity in the market for RFRs is also likely to be a restraining factor from the start.

In the UK, the Working Group on Sterling Risk-free Reference Rates (Sterling RFR Group) has recommended that GBP LIBOR should be replaced by the Sterling Overnight Index Average (SONIA). The confirmation of this replacement on 29 November 2017 by the FCA further underlines the importance of understanding the potential impacts and practical considerations of the transition.

Other countries such as the US and Switzerland have identified secured RFRs to replace LIBOR, namely the Secured Overnight Financing Rate (SOFR) and Swiss Average Rate Overnight (SARON), respectively. This would pose further challenges in regard to the transition as these rates are derived from secured transactions, removing the credit element that served as an important function in pricing and hedging. Furthermore, since its debut in April 2018, SOFR has been significantly more volatile compared to LIBOR due to its susceptibility to price swings tied to the Treasury bill issuance as well as month- and quarter-end supply variations.

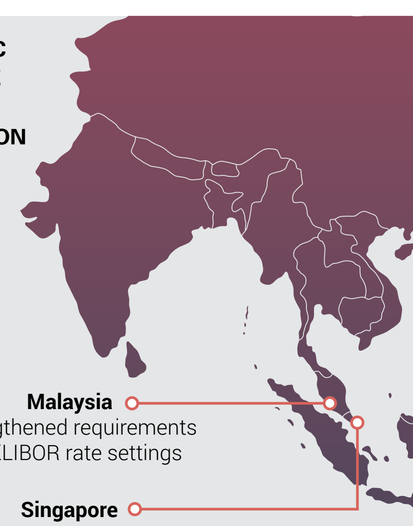
In the Asia-Pacific landscape, regulators and the financial industry are mostly at the initial stages of looking into the impact of this transition, however, the progress is moving at a slower pace than expected.

To support the transition to RFRs, working groups such as the Sterling RFR Group in the UK and the Alternative Reference Rates Committee in the US are continuously putting effort to build forward-looking RFRs, issue consultation

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

Mark Carney, Governor of the Bank of England

ASIA-PACIFIC LANDSCAPE ON LIBOR TRANSACTION



Malaysia
Strengthened requirements for KLIBOR rate settings

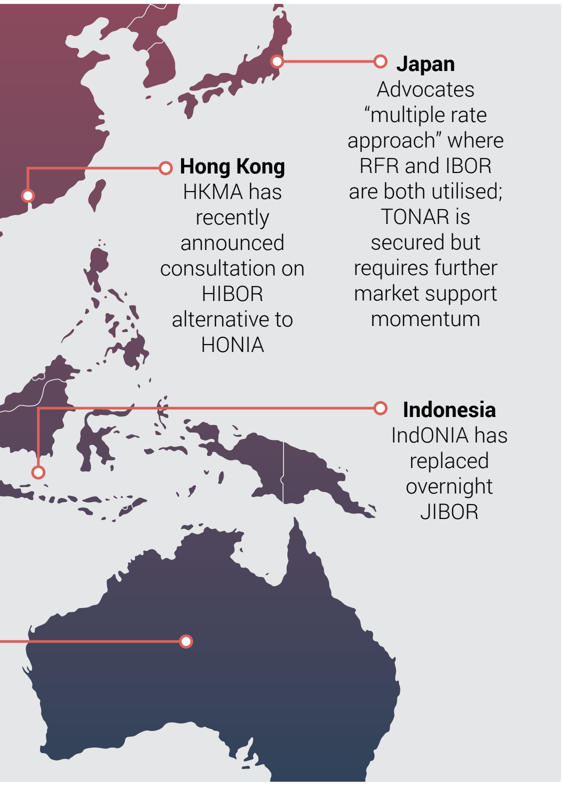
Singapore
SIBOR will remain the SGD benchmark; detailed consultation process undertaken for calculation methodologies

Australia
The Bank Bill Swap rate has been strengthened by extending the set of actual transaction used in calculations and introducing a volume methodology of bank bill transactions

TABLE 1 POTENTIAL IMPACT OF THE TRANSITION OF LIBOR

AREA	LEGAL	SYSTEMS AND PROCESSES	VALUATIONS AND RISK MANAGEMENT	ACCOUNTING	TAX
Potential Impact	Contract amendments will lead to increased transition costs and operational risks. A significant administrative effort associated with transitioning contracts to the alternative RFRs will be required.	Significant challenges may arise when the required institutional infrastructures (e.g. trading and clearing data, systems, and operational procedures) are established to support the transition to the alternative RFRs.	Transition of legacy contracts could potentially result in less effective hedges and/or market valuation issues, and may require adjustments to address inherent differences between the interbank offered rates and alternative RFRs.	The transition may result incomplications related to fair value designation, hedge accounting and inter-affiliate accounting structures.	The transition may result in changes in the amount of taxesdue or acceleration of payments on financial contracts or tax structures.

papers and guidelines, and build liquidity in the market via publishing of indicative rates using derivatives launching and trading of new RFR products such as swaps and futures. The US has been at the forefront of these initiatives, with CME Group, the world's largest derivatives marketplace, launching SOFR futures in May 2018. Across the Atlantic Ocean, British clearing house LCH began clearing interest rate swaps referencing SOFR



just two months later. Intercontinental Exchange has also expanded its offering by launching various tenures of SOFR futures. Despite their efforts, LIBOR-referenced products are still heavily used and traded today. According to the Bank of England, LIBOR exposures are growing faster than they are maturing.

THE TIME TO ACT IS NOW

While many market participants in the US and UK have already embarked on transition programmes, globally, the pace of transition is not accelerating. This is, in part, due to the absence of any formal regulatory or legal mandate. However, banks have to accept that the discontinuation of LIBOR is not a possibility, but a certainty. Banks have to act now. Regulatory and supervisory scrutiny is expected to grow, with focused intervention in areas that are underdeveloped. Boards and senior management should expect questions regarding their timelines, governance plans, assessment of financial exposures and conduct risks, with enquiries becoming more focused and detailed over time.

It is important for banks to establish a Steering Committee (SteerCo) that comprises of all relevant business units and stakeholders (including the control functions or 'three lines of defence'), to manage and oversee the LIBOR transition programme. A balanced governance structure is vital, as the SteerCo will ultimately be the primary decision-taker in relation to the programme. Its membership needs to be sufficiently senior to enable it to take decisions which commit the business (first line) and engage the control functions, without becoming so large as to impair its ability to take decisions efficiently and effectively.

A disorderly transition from LIBOR would be detrimental to individual firms as well as to the broader market. There is, therefore, a strong incentive for each individual bank to perform an impact analysis, identify key risks and challenges, and manage these risks as early and efficiently as possible to avoid problems further down the line. Above are some of the potential impacts that may arise during the transition period (see **Table 1**).

LIBOR transition will be like no other transformation programme that banks have undertaken. While firms may consider 2021 to be a long way off, the fact is that the complexity, magnitude and scope of the task ahead allow no room for complacency. The clock is ticking and the time to act is now.

For more information on how your bank can build a holistic LIBOR transition programme, please refer to Deloitte's thought leadership paper, LIBOR transition – Setting your firm up for success: *https://www2.deloitte.com/uk/en/pages/financial-services/articles/libor-transition-ibor-benchmark.html* ✱

■ *Justin Ong is FSI Financial & Regulatory Risk Leader of Deloitte Malaysia. He can be contacted at keaong@deloitte.com.*