TNP White Paper Series | May 2020 revision

Reference Rate Reform

IBOR in the time of Corona

TRUE NORTH PARTNERS
FINANCE | RISK | STRATEGY

Executive Summary

- The headwinds experienced as a result of the Coronavirus (Covid-19) have raised questions as to whether the LIBOR transition timeline may be extended.
- While some extensions in the interim milestones have been announced, there is little regulatory appetite to discuss an extension of the December 2021 deadline.
- Even in a scenario where the final deadline is extended, ***the transition objective will never be put into question***. Therefore, financial institutions putting on hold their own transition effort will only defer (if not increase) implementation costs to the future.

1 Introduction

With the Basel Committee announcing the deferral of the Basel III implementation timelines by one year,[1] the rumours around and calls for an extension of the Libor transition implementation timelines are getting louder.

On the 29th of April, the UK Risk Free Rate Working Group (RFRWG), the FCA and the Bank of England issued a joint statement extending the interim transition deadline for the issuance of Libor linked *loans* in the UK from end of Q3 2020 to end of Q1 2021.[2]

This latest joint statement comes in addition to the one issued on the 25th of March, whereby the three bodies emphasised that “it remains the central assumption that firms cannot rely on LIBOR being published after the end of 2021.”[3]

[1] https://www.bis.org/press/p200327.htm
[2] https://www.fca.org.uk/news/statements/further-statement-rfrwg-impact-coronavirus-timeline-firms-libor-transition-plans
[3] https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans

"The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet. The transition from LIBOR remains an essential task that will strengthen the global financial system. Many preparations for transition will be able to continue."

FCA, Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates joint statement, 25 March 2020

The same assumption was echoed by the US's ARRC in their published 2020 Objectives.[4]

Separately, European Association Clearing Houses (EACH) announced that they have extended the live date for €STR discounting and Price Alignment Interest by 5 weeks, to the 27th of July 2020.[5]

2 Context and implications

The 29th of April joint statement comes as no surprise, as the UK regulatory bodies had already indicated that an extension of the *interim* transition deadlines is likely. One of the main drivers for this extension – *applicable to the loan markets only* – has been the need for (LIBOR linked) emergency loans softening the economic impact of the pandemic on small and medium sized businesses in the UK.

However, the extension did not come without constraining parameters, namely:

- Despite the extension, lenders should be able to offer non-LIBOR linked products to their customers from the end of Q3 2020.
- All new and refinanced LIBOR referencing loan products should include clear contractual arrangements that facilitate conversion to SONIA or other alternatives ahead of end 2021, through pre-agreed conversion terms or an agreed process for renegotiation.

In a similar manner, the Federal Reserve in the United States issued a statement[6] which *reversed its original intention* to have the Coronavirus Aid, Relief and Economic Security (CARES) Act[7] loans linked to SOFR. As several of these loans will be of a tenor

[4] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_2020_Objectives.pdf
[5] https://www.lch.com/membership/ltd-membership/ltd-member-updates/transition-to-%E2%82%ACSTR-Discounting-Updated-Timing
[6] https://www.federalreserve.gov/monetarypolicy/files/main-street-lending-faqs.pdf
[7] https://home.treasury.gov/policy-issues/cares

extending beyond the end of 2021, lenders should include appropriate fallback contract language accounting for the cessation of LIBORs.

In a somewhat unrelated development, the European Association Clearing Houses (EACH) announced that they have agreed to extend the live date for €STR discounting and Price Alignment Interest to the 27th of July 2020, an extension well short of the September 2020 date requested by some participants.[8] This decision does not affect other benchmark reform milestones, for example the transition to SOFR discounting in the US market scheduled for 19 October 2020.

While this extension is likely to assist with managing the impact of the pandemic on the workload of institutions and the requirement for staff to work remotely, it does not come without its challenges. Several market participants noted that the majority of the work had already been completed or that their planning for the changes in June had not been affected by their crisis. Additionally, the delay will complicate matters for swaps issued with the June transition date in mind, and for bilateral swaptions delivering into cleared swaps.

3 What are the options for regulators?

The extension of the interim transition timelines, in conjunction with the increasing stock of LIBOR linked loans and the uncertainty around the evolution of the pandemic, is likely to put pressure on regulators to reconsider the final transition date and / or provide additional guidance on the calculation of RFRs, fallback clauses and more prescriptive guidance on spread and other transition adjustments.

The ‘hard’ approach - mandate an extension of LIBOR submissions

A ‘hard’ approach would be for the FCA to require LIBOR panel banks to extend submissions beyond the end of 2021. This date, however, is still quite remote and therefore unlikely to be discussed officially any time soon. Given the aforementioned statements, such an approach is highly speculative.

The ‘soft’ approach - voluntary extension of LIBOR submissions

An alternative possibility is that the LIBOR panel banks may *voluntarily* agree to continue submitting LIBOR rates beyond the deadline. This is an option, but a rather unlikely one in the absence of regulatory decree. Other than the conduct risks associated with voluntary submission, panel banks are the ones that have made the

[8] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/20200407/2020_04_07_WG_on_Euro_RFR_meeting_minutes.pdf

most transition progress and such a voluntary act would largely benefit institutions that are further behind in their efforts.

Reform the calculation of RFRs

Spreads between (backward looking) RFRs and (forward looking) LIBOR rates have widened over the last few weeks. In early March, the three month USD LIBOR dipped 31.4 basis points to 1.00063%, the largest one day drop since the height of the global financial crisis in October 2008.[9] A few days later, the basis between three month LIBOR instruments and SOFR OIS peaked at 48bp, up from just about 13bp in late February.[10]

It is not the first time that *actual* experiences with the behaviour of RFRs have called for a reconsideration in the calculation of alternative rates. Following the glut in the US repo market in late 2019, the Federal Reserve Bank of New York (the administrator of SOFR) has started publishing 30, 90 and 180 day SOFR averages as well as a SOFR index.[11] Similarly, the Bank of England has agreed to publishing a daily SONIA Compounded Index.[12]

It is also worth noting that the spread between €STR and EONIA is fixed at 8.5 bps, while the basis between the Fed Funds rate and SOFR is not.

In other words, it would not be unheard of if the calculation of RFRs has to be redrawn one more time.

---

[9] https://www.bloomberg.com/news/articles/2020-03-04/libor-plunges-most-since-2008-as-rate-catches-up-to-fed-cut-bets
[10] https://www.risk.net/derivatives/7504636/pandemic-threatens-libor-transition-plans
[11] https://www.newyorkfed.org/markets/opolicy/operating_policy_200212
[12] https://www.bankofengland.co.uk/paper/2020/supporting-risk-free-rate-transition-through-the-provision-of-compounded-sonia

Ease implementation by offering more prescriptive guidance

Over the last few days, several regulatory bodies have published additional guidance on the treatment of accounting rules, given the economic uncertainty arising from the Covid-19 pandemic.[13] [14] [15] A similar approach may be expected, if not encouraged, from ARR transition working groups and bodies. For example, *voluntary* options pertaining to fallbacks[16] may have to be removed and solutions be prescribed[17] in the light of developments, to reduce inconsistency in market practices and implementation approaches.

4 What are the options for banks?

Under the light of recent developments and the ensuing uncertainty, banks have a number of options in their IBOR transition programmes. As we can see, these options are merely theoretical, as the work has to continue albeit in a different context.

Maintain transition momentum but proceed with realism

Banks should assume delays in the implementation effort as reality. Dealing with market volatility and continuing essential banking operations undoubtedly become a priority. At the same time, the challenges of remote working and the disruption of established project management procedures call for realism, but *without the loss of momentum*.

Banks should assume that the December 31 2021 deadline will not move and reconsider their internal transition plans to account for the inevitable slowdown in progress. With staff having to work remotely for the foreseeable future, a re-stated transition plan needs to offer a realistic target against which effort has to be aligned, while the end goal remains unchanged.

Postpone implementation effort

Without a doubt, this is a rather risky approach. Especially for financial institutions that are further behind in their transition efforts (or which have not really started yet), such an option should be evaluated in the context of others that are well ahead and would be rather reluctant to accept costly delays unnecessary to them. We should expect a fair bit of pressure from transition leaders on regulators to keep the final

---

[13] https://www.ifrs.org/news-and-events/2020/03/application-of-ifrs-9-in-the-light-of-the-coronavirus-uncertainty
[14] https://www.esma.europa.eu/press-news/esma-news/esma-issues-guidance-accounting-implications-covid-19
[15] https://www.fca.org.uk/news/statements/delaying-annual-company-accounts-coronavirus
[16] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Apr-25-2019-announcement.pdf
[17] https://www.risk.net/derivatives/7513481/libor-webinar-playback-spotlight-on-loans

deadline as is, in a political tug-of-war where it is obvious where the balance of strength lays.

Even in a scenario where the December 2021 deadline is extended, the final transition goal will never be put into question. Therefore, being unable to offer ARR-linked products to clients may result in a loss of market share and even costlier transition programmes in order to play catch up.

5 Concluding remark

Whether financial institutions, in a Gabriel Garcia Marquez sort of way, return all the letters back to the regulators and whether the relationship between the two of them proves to be as faithful as assumed, remains to be seen. But as the uncertainty regarding transition timelines does not impact the overall transition end goal, delaying effort will only result in deferring (if not increasing) implementation costs to the future.

> *"Some say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes, and the end of LIBOR."*
>
> *John Williams,*
> *President and CEO of the Federal Reserve Bank of New York*

TRUE NORTH PARTNERS

FINANCE | RISK | STRATEGY

TRUE NORTH PARTNERS

True North Partners LLP is an independent consulting firm based in London, Johannesburg, Frankfurt and Dubai.

We specialise in finance, risk and strategy and have extensive global experience and industry recognition in the financial services, risk management and finance communities.

Our distinctive value proposition includes three key elements

- Leading practice expertise and experience
- Strong analytical grounding
- Senior on-the-ground presence

CONTACT THE AUTHORS

Dr. Periklis Thivaios CFA, FRM

periklis.thivaios@tnp.eu

Graham Bruce

graham.bruce@tnp.eu

Rohit Joshi

rohit.joshi@tnp.eu

Niruvashnee Govender

niruvashnee.govender@tnp.eu

London | Johannesburg | Frankfurt | Dubai

www.tnp.eu | info@tnp.eu

linkedin.com/company/True-North-Partners-LLP