IBOR Transition

An Update on the IBOR Transition Compass

1. FORRS Recap

After multiple fraudulent actions affecting LIBOR, one of the most important benchmarks in the financial world will vanish. With precise dates and circumstances still unknown, there will be an enormous impact on trading, valuation, risk, and other activities reaching from front to back office. It looks like successors for the IBORs have already been found. Risk-free rates (RFRs) for each currency such as SOFR for USD, €STR for EUR and SONAR for GBP satisfying profound requirements of the EU Benchmark Regulation (BMR). These rates are overnight rates and published daily, indicating a risk-free interest rate for overnight lending. One big step filling the LIBOR to RFR transition gap is developed by the International Swaps and Derivatives Association (ISDA) via the implementation of RFR based fallback rates for legacy contracts referencing on IBORs. Nevertheless, the efforts taken by ISDA are only a part of the solution. Missing term and credit components, a lack of liquidity, structural impact on legacy and future issues, COVID-19 and a rough time schedule make the LIBOR transition way more than just a replacement of a figure.

2. Latest Observations on IBORs and RFRs

The expectation of the market participants was that more products referencing to RFRs would have been traded at this point in time. One of the reasons why this is not the case is the COVID-19 pandemic. The impact of the crisis on the IBORs was immense and scathingly revealed their weaknesses. In mid-March of this year, most of the LIBOR quotes had not been based on real transactions. Regarding regulation COVID-19 led to prolongation of existing deadlines. Nevertheless, the Federal Conduct Authority (FCA) does not force panel banks to quote LIBOR after 2021, which even calls LIBOR existence starting 2022 into question. On the other hand, a deadline for banks to stop new Sterling LIBOR linked lending was postponed to March 2021 complying with the need of extra time for market participants.

A silver lining regarding LIBOR transition is the ISDA fallback protocol which will be finally announced in the next weeks. Bloomberg is already publishing LIBOR fallback rates and adjusted reference rates that ISDA intends to implement for multiple currencies and tenors. Another step to get away from LIBOR already took place end of July this year. The clearing houses Eurex, CME and LCH began calculating price alignment interests based on €STR instead of EONIA for EUR-based interest rate swaps. It is worth mentioning that since October 2019 EONIA is defined as €STR plus a spread of 8.5 basis points. The impact of the clearing house transition from EONIA to €STR together with the expected rise in liquidity is well observed – the switch from USD LIBOR to SOFR is just around the corner. Liquidity in products which are based on risk free rates is indispensable. Therefore, in the wake of the COVID-19 crisis the US FED planned to issue 600 USB BN referencing on SOFR via four year loans. The project was aborted after remonstrances of market participants when USD LIBOR was allowed as well. The following diagrams illustrate the RFR usage in LCHs Swap Clear.

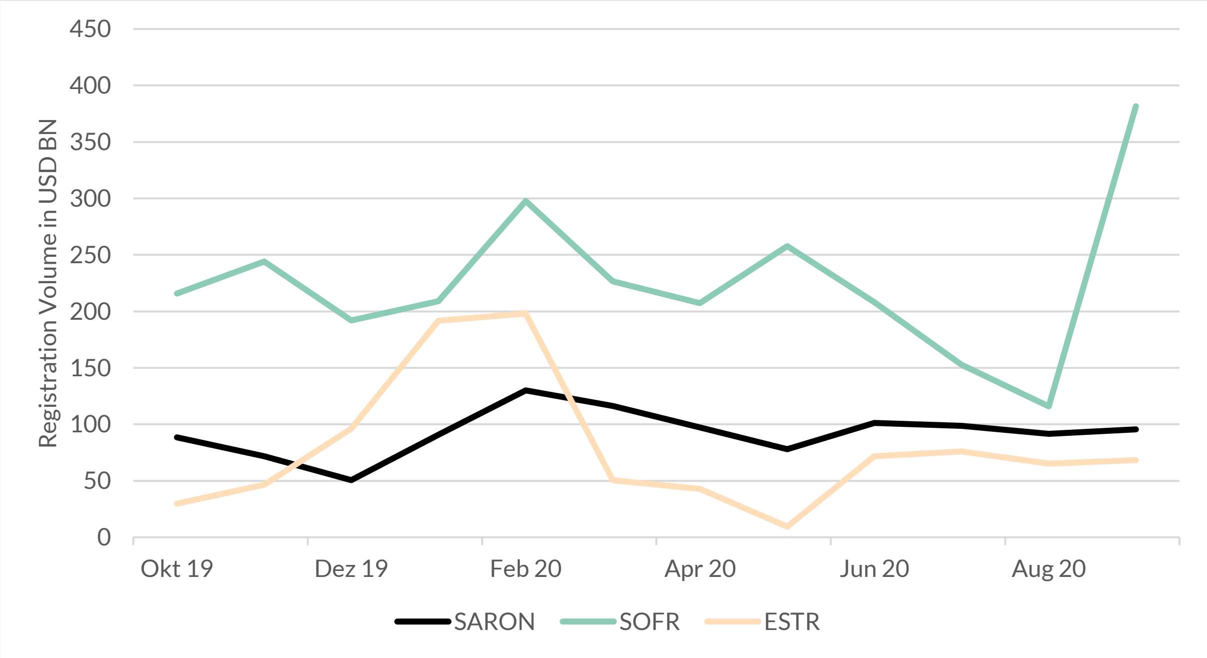

Figure 1: LCH Swap Clear RFR Statistics[1]

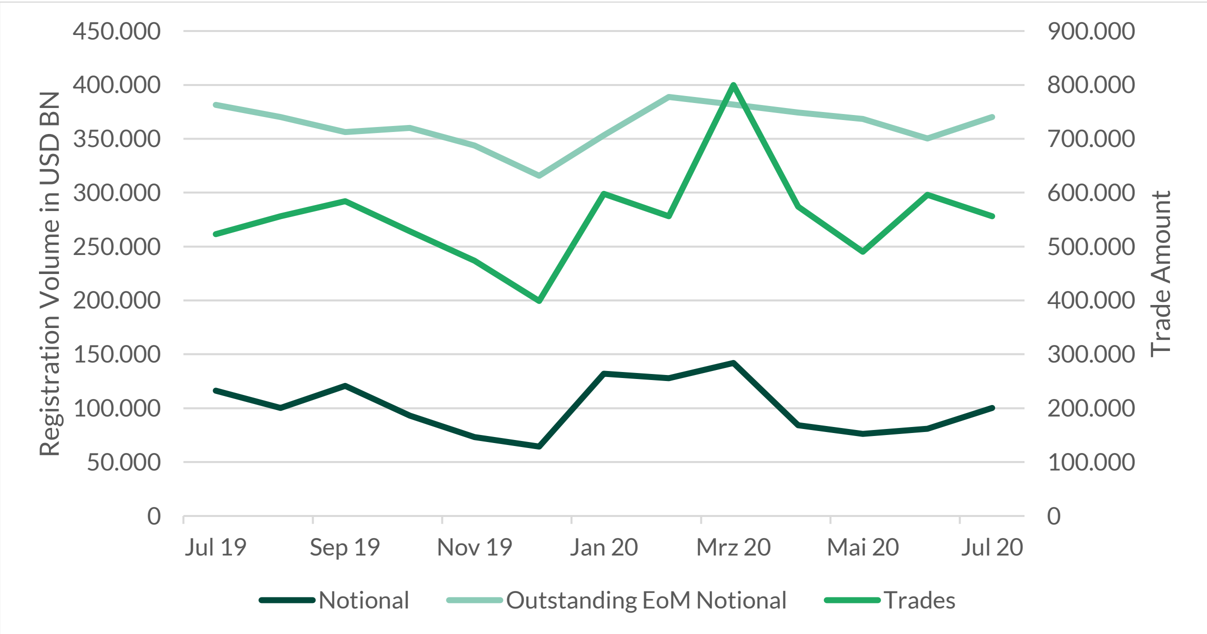

Figure 2: LCH Swap Clear Monthly Trade Statistics[2]

[1] See https://www.lch.com/services/swapclear/volumes/rfr-volumes
[2] See https://www.lch.com/services/swapclear/volumes/monthly-volumes-swapclear-global

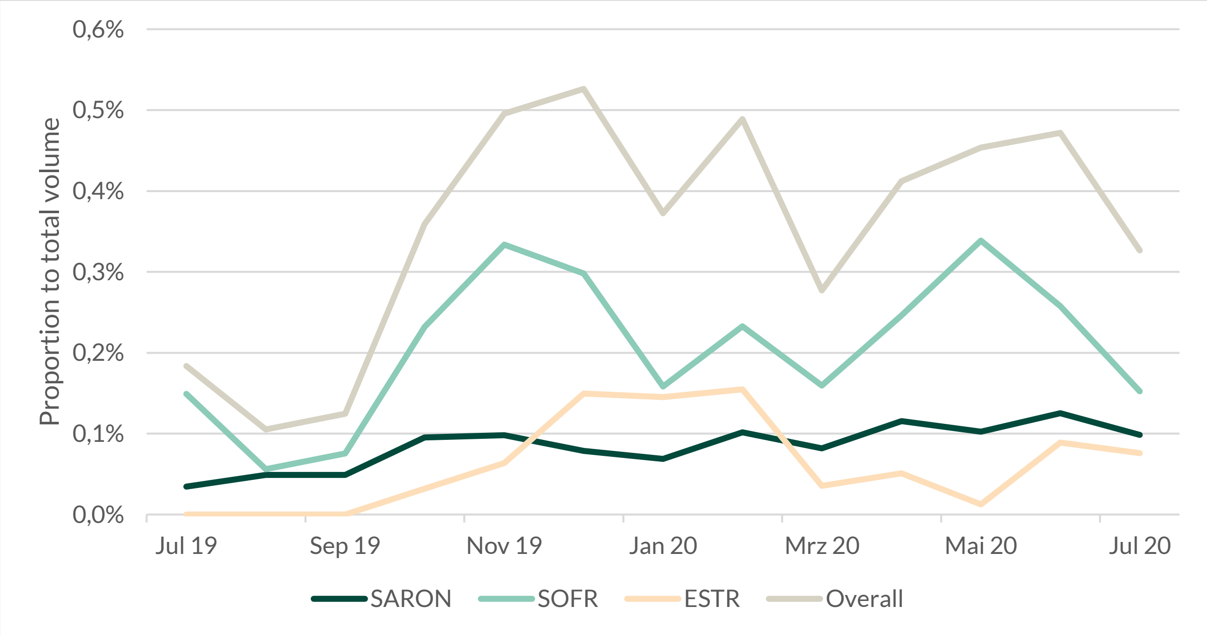

Figure 3: RFR proportions

The diagrams show that the traded volume based on RFRs did not increase but even decrease proportionally to the total volume over the past months apart from the dramatic increase of SOFR linked swaps in September. The reason could be the preparation of the beforementioned SOFR switch for discounting future cashflows of cleared US dollar interest rate swaps. Overall, COVID-19 could have awakened the need to act in the present and therefore postponed forward looking activities.

Previous diagrams plot the RFR usage in LCHs SwapClear indicating a sideways movement, but swaps might not be the only asset class experiencing stagnation. Interest rates are at extreme lows and will most likely remain on this level. One might conclude that the buy side has a lower demand to purchase interest rate swaptions which counteracts incentives for banks to migrate offered swaptions from LIBOR to RFRs. Furthermore, interest rate swaptions are often used to hedge interest rate risk for loans. These loans are mostly referenced on LIBOR. Therefore, a hedge using a product referencing on RFRs might fail its purpose.

Missing tenor and credit components are crucial aspects when IBORS are replaced by RFRs. Regulators agree with these objections from market participants. Even a Credit Sensitivity Group was established to meet the markets need of a credit adjustment especially for SOFR and €STR. SONAR is based on unsecured overnight transactions and therefore has a big advantage regarding this point.

3. Future Challenges

Structured products are commonly traded to hedge other products or existing exposure. If parts of the products shift to new RFRs, are covered by a fallback protocol, are terminated or renegotiated bilaterally, positions which have already been hedged might behave different than expected. Furthermore, single products can lose their characteristics by adapting the underlying reference rate, options referencing one-month LIBOR as an example. The ISDA fallback is determined by the corresponding RFR – overnight rates for each day of the last month. This means that in this case the payoff depends on several rates in the past instead of one forward looking LIBOR rate. As the example shows these adjustments might result in a review of pricing and valuation models when moving from a forward to a backward-looking rate. But there are more to-dos for the sell-side. Institutions have the obligation to inform their customers how legacy products will change. However, larger market participants have usually better access to information which leaves small entities with a disadvantage. Banks themselves can be challenged by economic issues as lending might become unprofitable if the banks' funding costs are not covered by income resulting from lending based on RFRs. While lending based on LIBOR approximately covers funding costs, the income resulting from lending based on RFRs might not cover funding costs in times of economic crisis as banks could not trust each other and require high credit risk adjustments. Therefore, banks could desire adjustments to RFRs depending on the market's situation. As COVID-19 demonstrated, RFRs tend to decrease in times of crises when central banks push money to the market. In contrast IBORs tend to rise, as the build-in credit risk component, measuring the creditworthiness of counterparties, increases in time of crises.

Apart from the credit component, missing tenor adjustments distress the market. The forward-looking component of the IBORs is essential. Like the credit component issue there are already efforts to tackle this challenge. However, there is no solution yet and even estimations regarding a time horizon diverge. While some say there will not be a solution before 2022, the ICE is already working on a tenor sensitive version of the SOFR based on traded futures. If this rate will be BMR compliant is still open.

Risk professionals might be interested in future development of RFRs as well. With the Fundamental Review of the Trading Book (FRTB), each risk factor intended to be included in an internal market risk model has to pass the risk factor eligibility test. Central criterion for this test is liquidity – measured by the existence of so-called "real price observations". Looking at Figure 3, it is not self-evident that any RFR-related risk factor will pass this test.

To avoid any unpleasant surprises financial institutions should continue to:

- Stay involved in stakeholder communication and coordination
- Ensure operational readiness by educating staff and enhancing IT-systems
- Evaluate the currently used rates and fallback clauses
- Reduce legacy contract exposure and adopt the new RFRs

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