USD LIBOR transition – the last hurdle

Background

A major transition journey from the London Interbank Offered Rate (LIBOR), a key interest rate benchmark for both risk and performance, to other risk-free rates (RFRs) has been underway owing to various irregularities and expansion of regulatory expectations[1] and concerns related to its suitability going forward. This note looks at the current, and possibly the last, hurdle and provides some perspectives noted as at the start of March 2022.

Key highlights

Ubiquity: Instruments worth approximately USD 240 trillion are directly linked to LIBOR and instruments worth more than USD 175 trillion are linked to the Euro Overnight Index Average (EONIA)/Euribor, most of which have been transitioned.

Customer impact: The transition impacted a wide range of client segments, each with varying levels of sophistication.

Economic impact: Material differences between the current benchmarks and the alternatives had an impact on asset values and risk profiles, and the legacy fallbacks fundamentally changed product economics. This required careful analysis and deliberation.

Conduct/litigation risk: Financial Institutions (FIs) faced significant conduct and litigation risks owing to contracts restructuring and synthetic LIBOR, etc.

Uncertainty: The transition happened in the face of a multitude of end-state scenarios, across products and currencies.

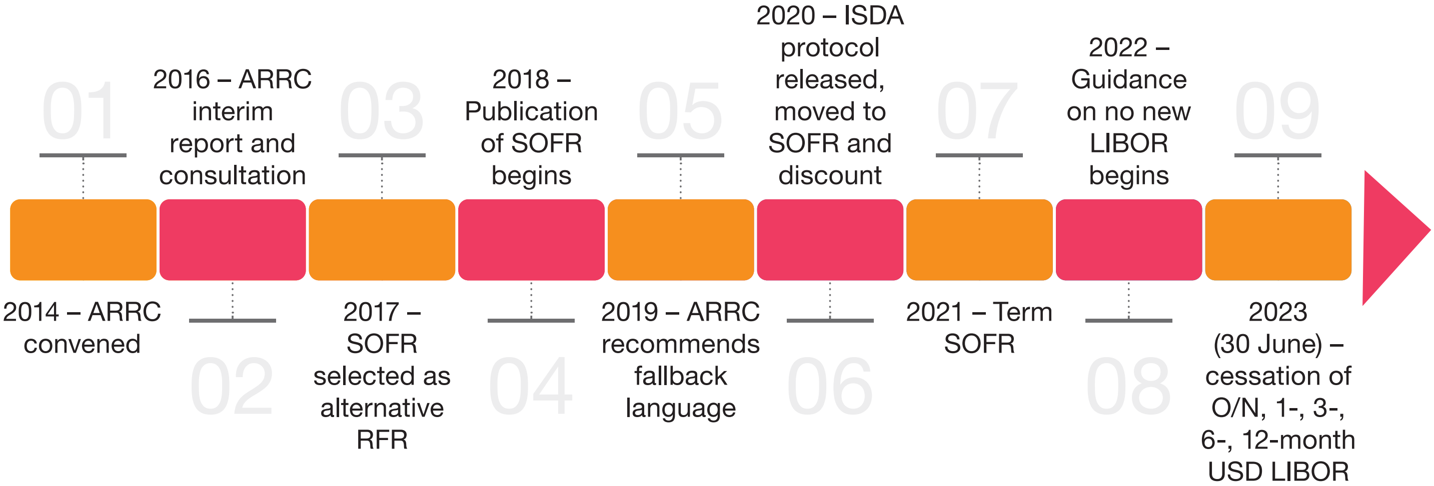
1 *https://www.fca.org.uk/news/press-releases/announcements-end-libor*

USD LIBOR transition journey

31 December 2021 marked the cessation of 1-week and 2-month USD LIBOR, while the publication of overnight and 12-month USD LIBOR will cease after 30 June 2023. Further, 1-month, 3-month and 6-month LIBOR will be non-representative from the same date. The Financial Conduct Authority (FCA) also communicated that it could consider the publication of 1-month, 3-month and 6-month LIBOR beyond 30 June 2023 on a synthetic basis.[2]

The Secured Overnight Financing Rate (SOFR) and Term SOFR have been finalised as the alternative rate for USD LIBOR by the Alternative Reference Rates Committee (ARRC).[3] There has been considerable adoption and progress in the transition away from USD LIBOR and the momentum should continue in 2022, till its cessation in mid-2023.

USD LIBOR transition timeline



*ISDA – International Swaps and Derivatives Association

2 https://www.fca.org.uk/news/press-releases/fca-confirms-rules-legacy-use-synthetic-libor-no-new-use-us-dollar-libor#:~:text=The%20FCA%20has%20confirmed%20it,of%20end%2D31%20December%202021.&text=These%20synthetic%20rates%20will%20not,use%20in%20any%20new%20contracts

3 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Term_SOFR.pdf

PwC's perpective on the USD LIBOR transition journey

'New use' of USD LIBOR	Disclosure documents	SOFR First for exchange-traded derivatives (post-2021)	Tough legacy
Begining Jan 2022, there will be well-controlled use of LIBOR as per the documented SR* Letters 21-12, 21-17 and 20-27,[4] which primarily constrains the creation of new LIBOR exposures or extending the maturity of existing exposures.	As LIBOR is still on and the fallback language[5] is in place, market participants should adhere to risk and fiduciary obligations. They are also liable to provide a 'detailed and specific disclosure' that includes both qualitative and quantitative information.	SOFR has been in use for loans and deposits, cash components and OTC derivatives. The scope of products has now been expanded (exchange-traded derivatives) to almost all products and market participants. All market participants, including banks, need to gauge the economic implications of any delay in LIBOR transition.	For trades that cannot be handled upon LIBOR's permanent cessation, a 'tough legacy' provision has been modelled and the legislation has been passed in the US House of Representatives. Once it is passed by the Senate,[6] it will provide much-needed breathing space by enabling market participants to deal with such clients.

*SR – Supervision and Regulation

Key areas where banks need support – our take on the last hurdle

Discounting changes

- Clearing house discount curve changes
- Fed funds to SOFR
- Bi-lateral credit spread adjustments (CSAs)

ISDA protocol and fallbacks

- Fallback adherence for various products
- Design of credit adjustment spread for various products

Go-forward trading

- Prohibition of new use of USD LIBOR
- Cease initiation of new USD LIBOR-linked products
- Redesigning of processes
- Operating model changes

Back-book transition

- Incorporation of robust fallbacks into existing contracts
- Transitioning exposure away from USD LIBOR to RFRs

Conduct risk and disclosures

- Weekly publication of LIBOR discousure control report
- Governance, communication with customers, conflict of interest, treating customers fairly and market conduct

Training

- Retraining of employees
- Creation of checklists
- Client communication
- Creation of learning hub

Given the above challenges in making the USD LIBOR transition, banks need to adapt flexible delivery models to manage pressures on transition programmes for both the approaching June 2023 deadline and beyond.

4 *https://www.federalreserve.gov/supervisionreg/srletters/SR2027.htm*
5 *https://www.isda.org/a/bdigE/RFR-Conventions-and-IBOR-Fallbacks-Product-Table-October-2021.pdf*
6 *https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20211216-usd-libor-year-end-transition-progress-report*

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