Leaving LIBOR

Surmounting the transition challenges

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The transition from LIBOR to alternative reference rates (ARR) is slated to happen in 2021. That's not far away given the amount of work and challenges that lie ahead.

CRISIL, an S&P Global company, is working on several fronts to offer smooth transitions to the new industry benchmarks.

In the milieu, CRISIL, in partnership with the Professional Risk Managers' International Association, recently hosted discussions with senior risk management professionals on the emerging challenges such as:

Transition impact assessment and structuring: For trade economics, clients, technical, accounting and processes

Methodology and risk: Inconsistent fallback provisions across products, challenges in creating new products based on ARRs, and risk model updates and development

Product strategy: New product and service design, and managing the economic impact on the existing LIBOR portfolio

Contract amendments and reporting: Changes to existing contracts and meeting new requirements for regulatory reporting

Technology, systems and operations changes: Front, middle and back office – all need to undergo significant changes to prepare for the transition to new ARRs

Following is a snapshot of the recommendations and considerations emerging from these discussions.

A. Transformation and change management

It is clear that regulators are compelling banks to act now and proactively lead this change.

The impact will be seen across divisions including Global Markets and Banking, Wealth Management, Retail, Prime Brokerage, and Asset Management.

Given this, an overarching program to govern the transition is an imperative. The key first steps would be determining who should own such a program and ensuring top-down program sponsorship.

Responses from Tier 1 and 2 banks indicate there are still many unanswered questions around the transition. These include downstream actions needed to be taken by the CRO, CIO, CFO and Legal functions.

There will likely be technology challenges when moving from one rate to another, especially for legacy systems at banks.

In terms of new benchmark rates, SOFR and SONIA are well advanced and new products have already been launched based on them.

However, many other benchmark rates are still in the early stages. For example, While ESTER went live in October 2019, there are still some objections to it within the industry as it is derived from the existing EONIA rate.

Issuance of LIBOR-based products has also continued despite the upcoming transition.

The refrain today is that the LIBOR transition process would be similar to the Brexit process – with no clear guidelines or path to the end-state.

B. Analytics

Lack of analytics around SOFR

A large Tier 1 bank has stated that, from a front office perspective, large banks are well ahead in terms of new products being traded based on new benchmark rates, updates to pricing models, and changes in term structure analytics. However, smaller banks, especially those outside the UK and the US, are lagging as they wait for more clarity.

SOFR is an overnight rate, whereas LIBOR is a term forward-looking rate.

The volatility of LIBOR-SOFR spreads can be high around month-end and quarter-end, while averaging can help smooth the term structure. There is a need for more liquidity in SOFR to have a more reliable term structure. The good part is, volumes have consistently increased every month since trading began.

Another area of challenge for trading desks will be to assess the impact (P&L) of movement to new benchmark rates for existing contracts.

A lot of work is expected in updating mathematical models and model validation, while extra stress-testing work will also be necessary.

C. Conduct risk

As per a large UK bank, the challenges on the retail side are more to do with customer management and communications to educate customers on the changes and impact they would see.

Sales and account/relationship managers will need a lot of training to manage existing customers and also to sell new RFR-based products to new customers.

The transition process could also create scope for market abuse, though the modus operandi may differ from what was observed in the case of LIBOR.

For banks, management of customer relations – both retail and wholesale customers – will be crucial.

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