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LIBOR Transition:
Background, Timeline and Consequences for affected Parties

by Martin Bonnet and Christian Scholten

"Our intention is that, at the end of this period (2021), it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR. It would therefore no longer be necessary for us to sustain the benchmark through our influence or legal powers."

Speech by Andrew Bailey Chief Executive of the FCA at Bloomberg London 27 July 2017

The UK Financial Conduct Authority (FCA), which is responsible for monitoring the LIBOR (for London Interbank Offered Rate) reference rate, has announced on 27 July 2017 its intention to dismiss banks contributing to LIBOR calculation from their obligation to participate in the LIBOR fixing from 2021 onwards. To support its decision, the FCA argues that LIBOR is based on an insufficient number of underlying transactions and also prone to manipulations.

Therefore, the possible scenario in which no pricing on LIBOR will be available from 2021 onwards, is realistic. As an alternative to LIBOR, national reference interest rates are currently being developed worldwide. The LIBOR transition impacts financial institutions at different levels and should be carefully prepared respectively initiated. The following article summarizes the issues at stake and provides insights into the challenges ahead.

Why is the LIBOR (probably) going to be decommissioned?

The LIBOR is a reference interest rate fixed daily in London for the interbank business. This rate is of crucial importance for the pricing of a vast array of financial products worldwide. To determine the LIBOR, the Intercontinental Exchange (ICE) surveys a pool of banks every day to come up with an average rate for interbank refinancing. The results of the survey are published daily in the form of an unsecured (i.e. non-collateralized) interest rate, with different maturities of up to 12 months and across five currencies (USD, GBP, EUR, CHF, JPY). LIBOR rates have been available since the 1980s, they represent one of the most important reference rates and are used actively by financial institutions around the world.

With the declining transaction volume in the market (-90% since the 2008 financial crisis), the determination of interest rates was increasingly based on the judgment of some experts and thus became more and more prone to price manipulations. After the disclosure of collusive actions by several banks contributing to LIBOR in 2012, doubts about the reliability of such a judgment began to arise and LIBOR finally fell into disrepute. The November 2017 announcement by the Financial Conduct Authority to discontinue LIBOR on 31.12.2021 has finally sealed its fate.

As a result, working groups were set up for each impacted currency to develop alternative reference rates (ARRs). In Switzerland, the main LIBOR-related activities are dealt with in the SNB working groups. As the impression grew that financial institutions were somewhat complacent about the LIBOR transition, FINMA issued a self-assessment questionnaire in January 2019. The deadline was set to April 2019 for the contacted financial institutions to report on their progress with regards to the LIBOR replacement initiatives. This has increased the pressure on financial institutions to analyse the impending impact and to initiate or accelerate the transition.

Why is the LIBOR so important for the financial markets? A few illustrative figures

The LIBOR is deeply embedded in today's financial markets - in Switzerland, the CHF-LIBOR is one of three elements of the Swiss National Bank's monetary guideline which sets a target range for a three-month period. In order to illustrate the extent to which LIBOR-related instruments are embedded in today's financial markets, a number of figures can be evidenced:

- The Financial Stability Board estimated in 2014 that LIBOR was used as the reference interest rate for contracts worth **USD 240 trillion.**
- The LIBOR reference rates are embedded in a wide range of credit products. For CHF-LIBOR, the largest portion is associated with **retail mortgages (USD 0.7 trillion), followed by commercial mortgages and corporate loans (USD 0.2 trillion).**
- In addition, LIBOR rates are widely used for the valuation of derivatives. The volume of OTC derivatives such as interest rate swaps, forward rate agreements or cross-currency swaps, which use the CHF Libor rate as a basis for calculation, **amounts to USD 6.1 trillion.**

LIBOR-decommissioning will represent one of the most far-reaching developments in the financial markets in the coming years.

Timeline

The following table summarises the important steps taken around the LIBOR transition, from the announcement by the UK Financial Supervisory Authority (FCA) in July 2017 to the expected discontinuation of the LIBOR fixing at the end of 2021. Consequently, most financial institutions have planned to establish their transformation projects in 2019/20.

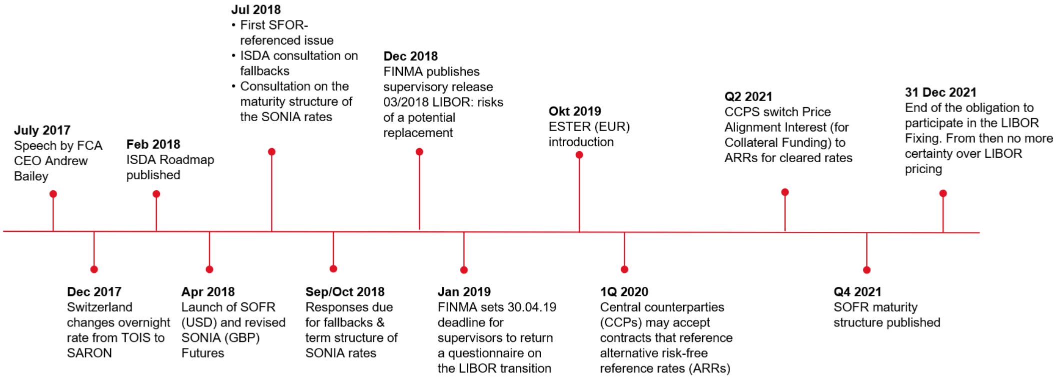

Figure 1:
Schedule of the LIBOR transition

Determination of alternative reference rates (ARR)

As mentioned above, in Switzerland a substantial volume of contracts - mainly mortgage loans and derivative contracts - is linked to LIBOR. The National Working Group for Reference Interest Rates in Swiss Francs (NWG) is the central body that prepares reform proposals to replace LIBOR. With the introduction of the Swiss Average Rate Overnight (SARON) before the 2017 FCA announcement, the NWG had already set a decisive milestone for the replacement of the Swiss franc LIBOR.

Other working groups, each responsible for one of the LIBOR currencies, have been evaluating different alternative reference rates (ARRs) to replace LIBOR. These ARRs are usually provided by official bodies such as central banks or stock exchanges and therefore leave little room for manipulation. Such ARRs already exist for four major currencies. However, there is no agreement regarding credit security ("secured" vs. "unsecured"); beyond that, it is exclusively about "overnight rates" that do not have a maturity structure (above 1-3-5 J).

The following table summarises the current situation for determining the alternative interest rate in the five currencies concerned.

Currency	Rate-Administrator	Working Groups	Alternative Reference Rate (ARR)	ARR description	Date of publication
CHF	SIX Swiss Exchange	National Working Group on CHF Reference Rates (NWG)	Swiss Average Rate Overnight (SARON)	• Secured (overnight repo rate) • Fully transaction-based	December 2017
USD	Federal Reserve Bank of New York	Alternative Reference Rates Committee (ARRC) Secured Overnight Financing Rate (SOFR)	Secured Overnight Financing Rate (SOFR)	• Secured (covers the entire repo market) • Fully transaction based • Solid underlying market	April 2018
GBP	Bank of England	Working Group on Sterling Risk-Free Reference Rates	Reformed Sterling Overnight Index Average (SONIA)	• Unsecured and overnight • Fully transaction based • Solid underlying market	April 2018
JPY	Bank of Japan	Study Group on Risk-Free Reference Rates	Tokyo Overnight Average Rate (TONAR)	• Unsecured and overnight • Weighted by transaction volume	December 2016
EUR	EZB, FSMA, ESMA und EU-Commission	Working Group on Risk-Free Reference Rates for the Euro Area	Euro Short-Term Rate (ESTER)	• Unsecured and overnight • Reflects the financing costs of banks in the euro area	Expected by 2020

Figure 2:
Working groups for ARR determination

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Impact assessment for affected parties

The replacement of LIBOR will affect all financial institutions and have tremendous material effects on commercial, procedural and technical aspects. The following graph highlights the affected business areas, including corresponding issues. Support from company management as well as early sensitization and mobilization measures among employees are also of great importance for the success of the transition.

According to BCG estimates, the implementation costs could amount to between CHF 50 and 100 million for small banks and CHF 350 million for system-relevant financial institutions. It is therefore important that the banks concerned create synergies with other regulatory and transformation initiatives. (e.g. update of the Risk Management Framework).

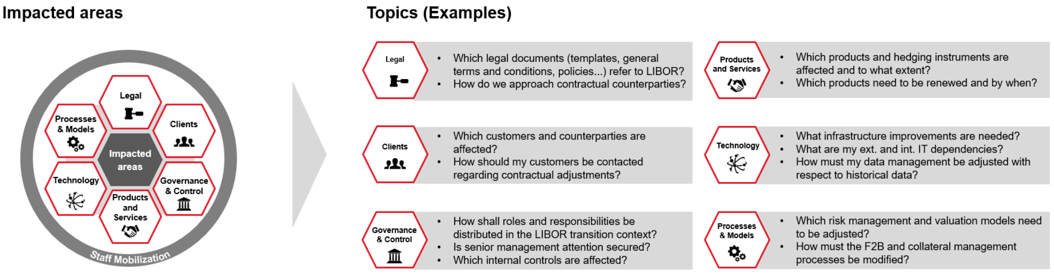

Figure 3:
Impacted areas within an financial organization and topics

Outlook

Despite significant progress by certain market participants in the selection of ARRs and transition planning, there is still no broad market awareness and understanding of the need to move from LIBOR to ARRs. Even among the largest financial institutions, there are potentially misplaced hopes that LIBOR will continue to exist. A market study published in June 2018 by ISDA and other associations found that although 87% of financial institutions surveyed were concerned about their own exposure, only 11% had allocated resources and budget for a transition program.

These findings are especially concerning given that interest rate reforms impose significant constraints for market participants, first and foremost the amendment of contracts with a maturity date occurring after the benchmark to which they are linked has been phased out. The arrangements and constraints vary depending on the type of product and the contract itself.

However, it is not too late to launch an impact assessment and awareness campaigns, as a preliminary to the 2020 implementation phase.

Determine the course with TALOS

TALOS has recently successfully implemented various regulatory projects (MiFID II, PRIIPS, GDPR...) and can leverage this experience to support you in an efficient and lean LIBOR transition. Using structured procedures, we can assess the impact of the LIBOR closure on your financial business. Together, we determine to what extent you are impacted and which solutions are possible. Our team will also help you to weigh up a suitable implementation strategy and can provide training for your employees.

For financial service providers who have already initiated the LIBOR transition, TALOS offers a "Health Check", in which the measures already implemented are analysed and a gap analysis with regard to compliance and market practice is prepared. For the follow-up project, recommendations will be drawn up that focus in particular on making efficient use of measures that have already been implemented.

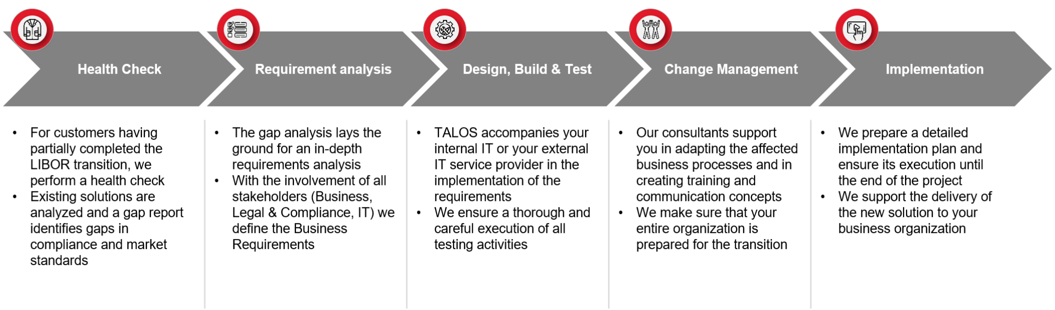

Figure 4:
TALOS Methodology

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