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IBOR transition: entering the endgame

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There have been numerous IBOR reform headlines over the past few months. Individually they may not have said much that is new, but cumulatively they send a clear message. As Andrew Bailey, the Governor of the Bank of England (BoE), stated on 13 July 2020, we are certainly entering the “endgame” of the IBOR transition. In Switzerland, the publication of compounded SARON rates by SIX in March 2020 or the “Dear CEO” letter sent by the FINMA to selected financial service providers on 09 April 2020, to name a few, underline this evolution. Also, on an international level, everything seems to indicate that the pace is picking up with affected institutions being urged to move quickly.

The end of the summer break is a good occasion to pause and digest the latest news flow while focusing on what has been achieved over the past months impacted by the containment of the COVID-19 pandemic and its consequences in the business life. Taking primarily the perspective of Switzerland, we will review the latest product, methodology and regulatory developments and highlight the major industry-wide agreements and achievements.

Market and regulatory developments have accelerated during the first half of 2020 and made the path towards IBOR cessation somewhat clearer. However, it remains key for project managers and executives having the responsibility on the transition to keep in mind the focus areas of the transition. We provide a practical checklist in the second part and outline how support can be offered during the course of the transition.

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IBOR transition: latest developments

Regulatory authority and professional associations generally appreciated that the COVID-19 pandemic had an impact on the interim transition timelines for firms and clients, causing delays to some aspects of transition. However, the deadline that firms cannot rely on IBORs beyond end 2021 remains the same. In the UK, the statement by the Financial Conduct Authority (FCA) on 25 March 2020 had been pretty clear to that extent: "Despite the Corona pandemic, 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". In Switzerland specifically, the disruption induced by COVID-19 has finally had a minor impact on the transition. This has been underlined by discussions the FINMA hold with affected stakeholders in March and April 2020, which confirmed that the Corona pandemic has not yet resulted in major delays to the IBOR transition, nor that there were major, structural obstacles for the transition of the CHF LIBOR cash market to the SARON. It should not come at a surprise then that the first half of the year 2020 has been so busy in terms of transition developments. Let us have a look at the most significant of those developments in terms of (i) products (ii) methodologies and (iii) regulatory and market supervision.

Products

The past months were characterized by an array of product launches by Swiss cantonal and regional banks, paving the way for a smooth transition with retail clients. On the derivatives side, progress is slower and institutions generally follow a wait-and-see approach depending on concrete client needs, relying on market-wide adherence to the forthcoming ISDA IBOR Fallback Protocol.[1]

Main product launches in Switzerland:

- November 2019: UBS announced it would provide a SARON real estate financing as part of a pilot project.[2]
- February 2020: Glarner Kantonalbank launches SARON retail mortgages[3] – The product is based on a five-calendar day “lookback” compounded SARON – A negative compounded SARON is floored on a 0 % level. This offering has been completed by SARON-based rollover mortgages in April 2020.
- February 2020: The Basler Kantonalbank and Entris Banking announced the first SARON based interbank transaction.[4]
- April 2020: Raiffeisen launches SARON based retail mortgages and business loans – The products are based on a «Plain» SARON compounded with a floor at 0 % level for negative compounded SARON.[5]
- May 2020: Luzerner Kantonalbank launches SARON-based mortgages[6]. The bank announced it would make a transfer offer to its mortgage clients from the second half of 2020.
- June 2020: Credit Suisse offers SARON rollover-mortgage as complement to existing SARON mortgages. [7]
- July 2020: Bank Cler started to propose SARON mortgages, following the general movement initiated by other major Swiss banks earlier in the year. [8]

Abroad, most significant progresses have been made in the UK where bank Lloyds for instance switched Riverside (UK housing association) to SONIA-linked revolving credit facilities. Progress in SOFR (USD) and €STR (EUR) facilities have been much more modest, at least on the cash product side.

Footnote:
1. https://www.isda.org/a/pFmTE/ISDA-Board-Statement-on-Adherence-to-the-IBOR-Fallback-Protocol.pdf

2. https://www.ubs.com/global/en/media/display-page-ndp/en-20191129-saron.html-en-2019-11-29-saron.html

3. https://www.glkb.ch/MedienArchive/20200203_Medienmitteilung_SARON.pdf

4. https://www.bkb.ch/de/die-basler-kantonalbank/medien/medienmitteilungen/2020/erstes-saron-basiertes-interbankengeschaeft-abgeschlossen

5. https://www.moneycab.com/finanz/raiffeisen-lanciert-als-erste-nationale-retailbank-saron-produkte/

6. https://www.lukb.ch/o/_/private/news/news-lukb-bringt-saron-basierte-hypothek-auf-den-markt

7. https://www.credit-suisse.com/about-us-news/en/articles/media-releases/credit-suisse-launches-comprehensive-offering-of-saron-mortgages-202006.htm

8. https://www.cler.ch/de/privatkunden/hypotheken-und-kredite/saron-hypothek189835853103

Interest rate calculation methodologies

The switch from IBORs to ARRs brings a dramatic paradigm change for the financial industry with it. While the LIBORs are forward looking rates, the ARRs are overnight rates which are "backward-looking" in their compounded version, i.e. calculated in arrears based on the average of the overnight rates over a certain period of time (1 month, 3 months, 6 months, 12 months). Affected financial institutions were looking for clarity to that extent, which has been partially brought as far as Switzerland is concerned.

Thus, at the end of March 2020, SIX launched SARON Compound Indices for various time periods while making its corresponding calculation methodologies public . The SNB via the National Working Group on Swiss Franc Reference Rates (NWG) recommended to use the lookback option for CHF mortgage and syndicated loans with an offset of five business days. Besides this standard method, six other calculations options (e.g. shorter offset, roll-over) are recognized based on specific bank needs or consistency with other currencies. You can find three of those seven recognized methods that are currently being applied by banks reflected in the figure below.

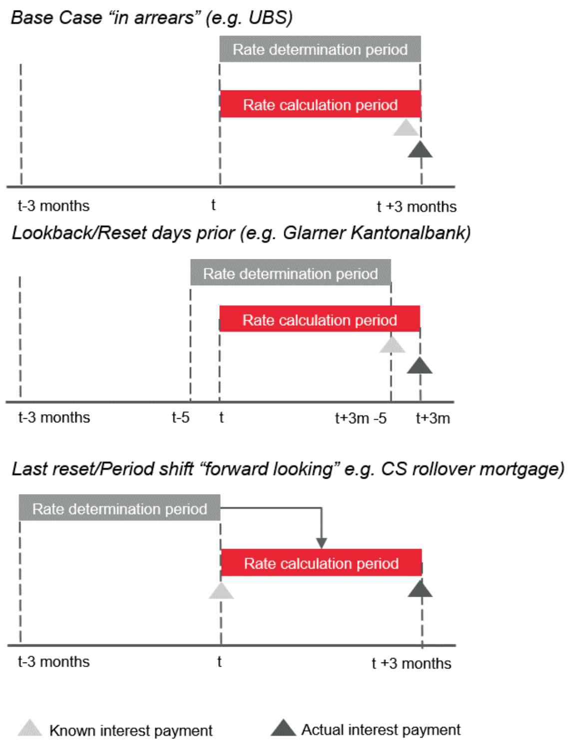

Figure 1:
Methodologies for interest fixing of SARON mortgages (extract)

Abroad, the BoE has been publishing a SONIA compounded index from 03 August 2020, following near universal support from the market participants. The aim of the SONIA compounded index is to simplify the calculation of interest rates for industry members and avoid the potential for different conventions about the compounding of SONIA calculation. Contrary to the SARON, there will be no publication of compounded SONIA over different tenors.

Regulatory and market supervision

Announcements by the regulatory authorities and the network of professional associations supervising the transition (e.g. ISDA) certainly had the goal to maintain or heighten the pressure on participants. At the same time, they demonstrate the willingness to offer standard transition solutions all markets participants will be invited to adopt. Goal is to foster an orderly transition and guarantee a fair and equal treatment of clients and counterparties

In Switzerland, the FINMA sent on 09 April 2020 its "dear CEO" letter to 26 Swiss banks and securities firms (coverage of 99.8 % of IBOR exposures with maturity after 2021) with self-assessment request by these firms by end of May 2020. This self-assessment on quantitative exposure is expected to be repeated on a quarterly basis until IBOR discontinuation. Beyond that, the letter is also communicating clear expectations to the supervised institutions in terms of operational and contractual readiness.

In May 2020, FCA and BoE postponed the ban on new GBP-LIBOR linked products to Q1 '21 (vs. Q3 '20) but stated that by October 2020 – UK banks should be offering alternatives to LIBOR. At the same time, the FCA stated that by end-Q1 2021, lenders and borrowers should take necessary steps to cease issuance of LIBOR linked loan products that expire after the end of 2021. This includes, by end Q3 2020 making non-LIBOR alternatives available and including contractual conversion mechanisms in new or refinanced LIBOR products.

On a more positive stance, the Working Group on Sterling Risk-Free Reference Rates (GBP RFR Working Group) announced on 29 May 2020 that it established a "Tough Legacy Taskforce" to consider the IBOR transition challenges for contracts that do not have robust fallbacks and prove unable to be amended ahead of IBOR discontinuation ("tough legacy contracts"). This is for example the case when:

- contracts form part of complex transactions or arrangements
- distribution is broad and there may be additional complications with obtaining the necessary consent
- retail counterparties are involved

Still in the UK, the government communicated on 23 June 2020 its intention to introduce amendments to the 2018 EU Benchmark Regulation (EU BMR), to ensure that, by end-2021, the FCA has the appropriate regulatory powers to manage an orderly transition which will protect customers.

On the same tone, on 24 July 2020, the EU Commission proposed to amend the BMR to give the EU Commission a power to designate a "statutory replacement rate" upon the IBOR cessation which that would automatically take effect in all IBOR-linked financial instruments subject to BMR between the supervised entities. Although the Commission said that the EU users of IBORs should continue their preparations for its cessation at the end of 2021, the prospect of such a legislative action may have major (positive) impact on the IBOR transition planning between financial institutions in the EU in simplifying the replacement framework.

Footnotes:
9. https://www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/compound_rates_en.html

10. https://www.snb.ch/n/mmr/reference/minutes_20200507/source/minutes_20200507.n.pdf

IBOR transition: readiness checklist

Based on our field experience as well as emerging guidance from the global regulatory authorities, we have listed below key considerations which should be thoroughly assessed when steering the IBOR transition. Those remain valid in spite of the standard solutions currently in place or considered.

Figure 2:
IBOR transition – impacted areas

Governance

- Appoint senior executives accountable for the IBOR transition program
- Establish a governance and project management framework than spans all impacted business lines and functions
- Create an IBOR working group to monitor market and regulatory developments, assist senior executives to implement the IBOR transition program and provide regular internal communications to all relevant stakeholders
- Consider and communicate early on time, budget and resources needed to implement the transition program and make operational changes
- Conduct a comprehensive impact assessment across key focus areas such as financial products, contracts and business processes (including IT systems and valuation models)

Product & Services

- Conduct a product exposure analysis to determine all IBOR-linked products for each line of business
- Continuously track these IBOR-linked products throughout the transition period
- Quantify exposures for IBOR-linked products maturing beyond year end 2021
- Establish a clear strategy and timeline for reducing IBOR exposure on new product issuance
- Define timelines for offering new ARR-linked products
- Define risks and new product approval requirements based on new ARRs

Risk Management

- Identify key risks resulting from IBOR discontinuation including market readiness, business impacts, financial and legal risks. Key financial risks include accounting treatment and valuation.
- Establish processes to measure and monitor these material risks
- Identify mitigating actions to all identified risks especially around product, operational and conduct risk
- Provide periodic update to senior management
- Update risk management framework accordingly

Legal

- Identify all IBOR related contracts that extend beyond the end of 2021
- For existing contracts with no fallback language or with fallback language that does not contemplate the expected permanent discontinuation of IBORs, either begin to
  a. amend these contracts to incorporate appropriate fallback language or transition them directly to an ARR; or
  b. determine if these contracts can be renegotiated, terminated or closed out prior to the end of 2021
- For new contracts that reference affected IBORs, make every effort to incorporate alternative fallback language catering for the permanent cessation of the IBOR
- Assuming a material number of contracts do not have suitable replacement fallback language, determine size and program needed to implement fallback language as written. With IBORs becoming permanently unavailable, these contracts could be subject to disputes or litigation if the parties of the contract fail to agree on a replacement rate or other fallback arrangements in advance

Technology

- Find out where IBOR is used across all affected business and operations front-to-back
- Develop a process to incorporate new market data sources and new calculation methodologies into the IT system
- Build testing plans for new product capabilities, models/validation
- Ensure readiness plan will have oversight of the readiness state of material operation and technology vendors
- Begin to plan for internal testing, third party validation/readiness for transition

Accounting & (Tax) Reporting

- Identify instruments that might be affected by accounting issues
- Assess impact on fair value accounting and impairment to profit & loss
- Identify impact and changes needed in current finance systems, operations, control environment and financial disclosures facilities

Communication

- Establish clear communication strategy to be used both internally and externally with counterparties, product issuers, regulators and industry bodies
- Develop communication materials such as learning materials, and newsletters for internal stakeholders, and provide training programs to all relevant staff
- Develop client communications and disclosures with input from legal, compliance and if needed, external advisors

LIBOR transition: determine the course with TALOS

Besides strong involvement in the IBOR transition itself, TALOS has successfully implemented various regulatory projects (MiFID II, PRIIPS, GDPR...) involving re-papering of the contractual documentation and extensive revamp of operational models. Using structured procedures, we can assess the impact of the IBOR cessation on your financial institution. Together, we determine to which extent you are affected 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 IBOR transition, TALOS offers a "Health Check" (see below), in which the measures already implemented are analyzed 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.

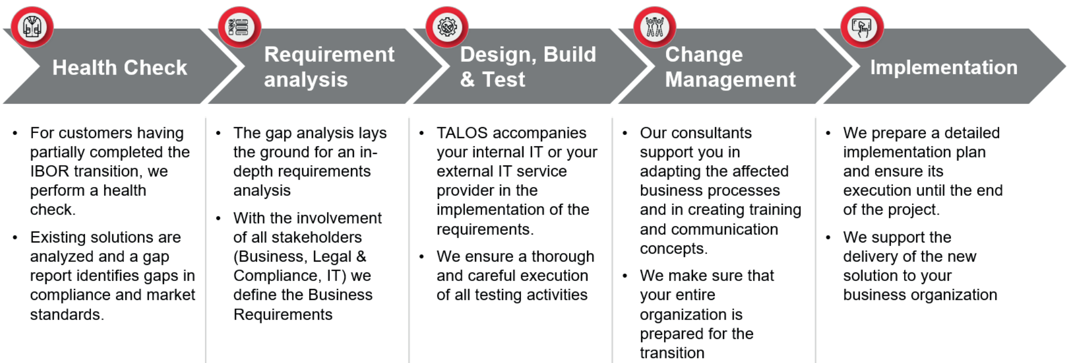

Figure 3:
TALOS Methodology

Glossary

ARRs: Acronym for alternative reference rates (ARRs), which have been established by the different working groups as successors to IBORs. As overnight, “nearly risk-free” rates, they are structurally different to forward looking IBORs and entail just a minimum credit and term rate spread. Administered by official bodies, those rates are more robust and more representative of actual underlying transactions than IBORs. In the IBOR transition context, ARR and RFR (risk-free rate) are synonyms and used interchangeably.
€STER: The Euro Short-Term Rate is an unsecured overnight interest rate administered by the ECB. The Euro RFR Working Group selected €STR as the RFR for the euro and as a replacement for EONIA.
Fallback (language): Contractual clause setting out the alternative rates (usually in the form of a waterfall of priority) which may become the benchmark rate where the originally referenced benchmark rate (e.g. LIBOR) is no longer to be used.
IBORs: Interbank Offered Rate(s) – for example, EURIBOR, LIBOR and TIBOR. The London Interbank Offered Rate (LIBOR) is the most widely known and used IBOR. The LIBOR is calculated and published daily at around 11:45 (London time) by the ICE Benchmark Administration Limited (IBA) based on submissions from panel banks for five currencies: Sterling, U.S. Dollars, Euros, Swiss Francs and Japanese Yen and in seven different tenors: overnight/spot next; 1 week; 1 month; 2 months; 3 months, 6 months; and 12 months.
ISDA: The International Swaps and Derivatives Association (ISDA) is a trade organization created by the private negotiated derivatives market that represents participating parties. This association helps to improve the private negotiated derivatives market by identifying and reducing risks in the market. ISDA is expected to publish a protocol during Q4 2020 to facilitate multilateral amendments of IBOR-linked derivative transactions.
SARON: The Swiss Average Rate Overnight, has been named by the Swiss franc RFR Working Group as its overnight risk-free rate (RFR)
SOFR: The Secured Overnight Financing Rate has been named by the ARRC (US RFR Working Group) as its recommended RFR alternative to LIBOR for US dollar denominated nominals
SONIA: The Sterling Overnight Index Average has been named by the Sterling RFR Working Group as its preferred RFR for sterling markets.

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Who we are

TALOS is continuously striving to shape new standards in management consulting. As a specialized consulting boutique of Swiss origin, we are serving the European financial services industry from our local offices in Zurich and Luxembourg.

Founded by experienced management consultants in 2008, we have grown since then to a renowned consulting company with a complementary service offering across various disciplines.

With our tailored hands-on approach, we accompany our clients in mastering the fundamental challenges the industry is facing.

We are a trusted partner for our clients helping them to increase their organizational effectiveness and operational efficiency.

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