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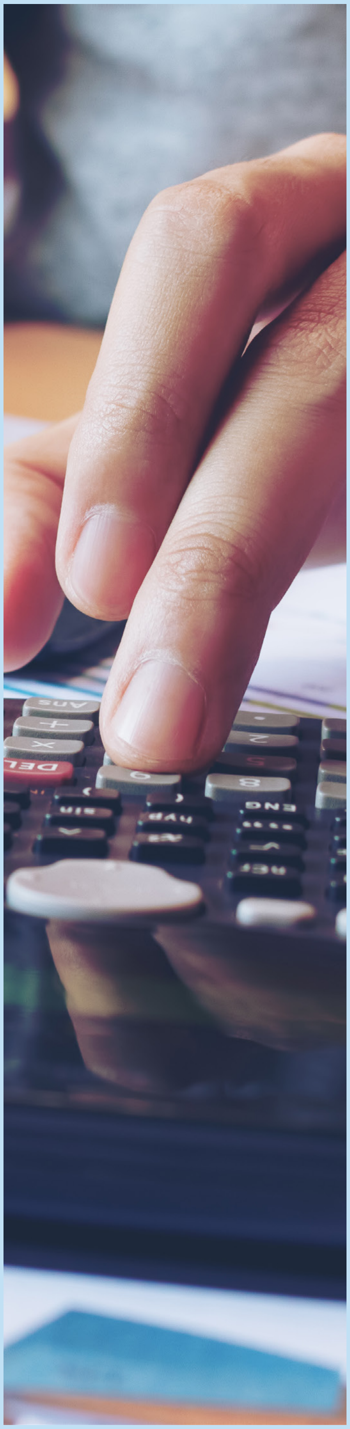

THE BIG SHIFT: PREPARING FOR A WORLD WITHOUT LIBOR

Overview

LIBOR (London Inter Bank Offer Rate), the interest rate at which banks lend money to one another for short term loans, is a globally accepted benchmark rate used to develop and offer wide range of financial products. Post considerable uncertainties in LIBOR supervision and administration, UK's FCA (Financial Conduct Authority) took the supervision from BBA (British Bankers Association) and delegated the administration responsibility to IBA (ICE Benchmark Administration).

The estimated size of the LIBOR linked products across the globe is $350 trillion. With FCA's announcement stating that LIBOR will see its end by 2021, and suggesting all the LIBOR users to opt for other risk free rates, now the biggest challenge in front of the financial institutions is to transition from LIBOR to other risk free rates. The shift away from LIBOR is going to have a far-reaching impact on stakeholders across the financial services industry.

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A slow demise

LIBOR reforms have been ongoing for several years. In 2014, the Financial Stability Board (FSB) realized that the methodologies used to calculate LIBOR were no longer relevant. With little or no information available when it came to reference transactions that determine the rate in the case of certain currency combinations, they found that these rates were highly dependent on expert judgment rather than transaction volumes. So, the regulatory body recommended a slew of measures that were aimed at improving the robustness and the effectiveness of the benchmark.

These measures included the implementation of a new code of conduct and ensuring that rate determination procedures were strengthened. However, despite the implementation of these reforms, a review found that LIBOR was no longer relevant. During Q1 2019, six-month LIBOR rates were being determined on the basis of just nine deposits per day, indicating that the banks that determine LIBOR were doing so on the basis of expert assessments rather than substantial trading data. Further, if these banks stopped submitting information altogether, that would mean a natural end for LIBOR. Therefore, by necessity the FCA has decided to end the LIBOR publication by the end of 2021 with the most likely alternative being to adopt other risk free rates such as SONIA (Sterling Overnight Index Average) for the UK, SOFR (Secured Overnight Financing Rate) for the US, and TONAR (Tokyo Overnight Average Rate) for Japan.

The far-reaching impact

At present, LIBOR is deeply imbibed in the working models of banks and other financial services institutions. Hence, the transition to a new risk free benchmark rates is likely to have a significant impact on LIBOR linked financial products such as loans, bonds, and derivatives. This shift may as well potentially change the core methodologies of pricing, predictive analytics, risks and other financial models, IT infrastructure, and current operations model.

The key functions most likely to suffer include commercial lending, capital markets, wealth management, retail banking, and investment management. In addition to these primary functions, some secondary functions that may be impacted are insurance, corporate treasury, and market infrastructure.

The specific area that is likely to suffer the most are the lending and derivative contracts. Typically devised on the basis of benchmarks like LIBOR, many existing contracts will need to be re-evaluated. As this will impact almost all mortgage customers and companies that have raised funds from the market, litigation risks will multiply. Furthermore, the budgets and strategic plans of financial services providers are likely to be stretched due to transition planning, and new hedging strategies will also need to be developed.

A detailed analysis with multiple consultations and observations concludes that there are three key major challenges in this shift, apart from the entire transition management:

1 Impact Assessment:

Consists of two key components

a. Quantifying the products that are linked to LIBOR and maturing beyond 2021

b. Impact of future pricing, yields and changes needed in the capital for the risk management

2 Repapering:

Redefining the terms and conditions in the trade agreements/contracts, or implanting fall-back provisions to the financial products that mature post 2021. The recommendations have been listed and observed on the fall-back provisions from various industry associations such as International Swaps and Derivatives Association. Syndicated loans are supervised by Loan Market Association for regions including EMEA, APLMA, and LSTA

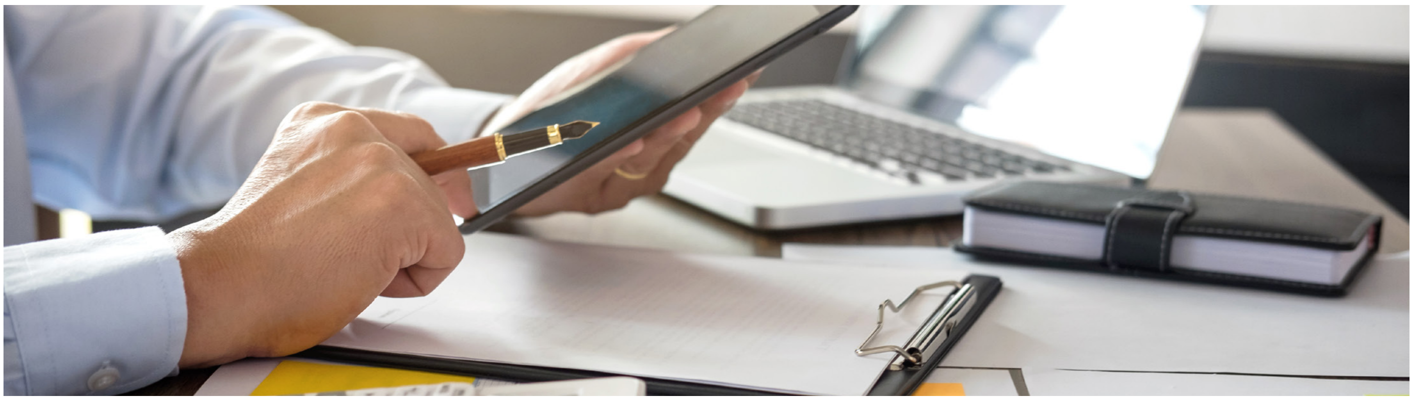
3 Remediation:

Remediation may potentially demand to change the current IT infrastructure and operations. Since already a massive number of applications are utilized to manage trade and client life cycle, it only increases the complexity of remediation

Crossing the bridge

Forward-looking firms around the world have already begun to plan for the shift with the most common approach adopted being the gradual phasing out and replacement of LIBOR-based contracts. A few examples of other risk free rates include SOFR (US), TONAR (Japan), and SONIA in the UK, with the first SONIA-referenced revolving credit facility in the UK already executed in July 2019.

The current approach adopted by organizations has major disadvantages. Re-evaluating and replacing each contract can be an extremely complex, costly, and time-consuming task with an adverse impact on business operations. However, if the banks start utilizing artificial intelligence (AI), machine learning (ML) based solutions, they can substantially improve on their operational efficiency. Considering the efforts required, it may potentially be a very costly affair for financial institutions as they might not have the necessary tools and workforce ready for such a complex transition.



Navigating the shift

Financial services firms need to have a comprehensive transition plan in place so that they can deal with the change. They will need to leverage a range of technology-driven methodologies to help minimize costs and ensure that core business processes are not impacted by the change. A technology partner help develops customized transition solutions covering the four major aspects of the transition utilizing AI and advanced data analytics tools on user inputs obtained through questionnaires. These solutions should necessarily over four broad areas:

1. **Transition impact assessment** - systematically assessing exposures and risks
2. **LIBOR transition planning** - addressing the requirements for remediation of processes and systems, customers, contracts, and regulators
3. **LIBOR contract review and remediation** - re-evaluating existing contracts to identify terms that may be affected and to initiate repapering efforts.
4. **Systems and process remediation** - planning, designing and testing of the transition changes required

The Way Forward

Even as the implementation of the new regulations is just over two years away, surveys of managers and companies have indicated that only about 18% are operationally ready for the change with banks and financial services providers continuing to launch products and services that are linked to LIBOR.

With over 5 trillion pounds of Libor swaps estimated to be outstanding even by 2026, only a few banks have begun the process of understanding the complexity and risks involved in the benchmark replacement. This is in spite of regulators actively seeking to prevent the market disruption and confusion that would trigger waves of lawsuits, regulatory fines, and penalties.

It is now imperative that financial services organizations begin to face the significant costs for changing terms of contracts, modifying systems and processes, and educating thousands of staff on the future operating models. For the industry as a whole, these costs will run into several billions of pounds, and only those firms that begin identifying and implementing holistic solutions for the changeover at the earliest stand to gain the most. Finally, the better and most appropriate choice to have a smooth and comfortable transition is, to go for it before the end of 2021.

This paper is a joint publication effort by:

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