Transition from LIBOR to alternative reference rates

Introduction

Overview

London Interbank Offered Rates (LIBORs), underpinning about US$400 trillion of financial contracts globally[1], has been described as “the world’s most important number”. However, the UK Financial Conduct Authority (FCA) announced that the LIBOR panel banks’ agreement to submit rates for LIBOR calculation would expire by the end of 2021 and FCA would not compel them to do so after that. Therefore, there is a very high chance that LIBOR will discontinue after end-2021.

The size, scale and scope of LIBOR usage make this shift arguably the biggest challenge facing the finance industry today. Regulators around the world have emphasized the importance for market participants to start planning the transition from LIBOR to alternative reference rates (ARRs).

This introductory material serves to provide the background of LIBOR and its transition, and highlight how businesses can prepare for the transition.

What is LIBOR?

- A wholesale funding rate anchored in LIBOR panel banks’ unsecured wholesale transactions to the greatest extent possible, with a waterfall to enable a rate to be published in all market circumstances. Panel banks’ submissions can be based on (i) transaction-based data; (ii) transaction-derived data; or (iii) expert judgement.
- Published on each London business day in five currencies (GBP, USD, EUR, JPY and CHF) and seven maturities (overnight, 1 week, and 1,2,3,6 and 12 months).

Why is transition needed?

- **The LIBOR scandal:** the event involved a series of manipulative and

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[1] https://www.bis.org/publ/qtrpdf/r_qt1903e.htm

fraudulent actions during the financial crisis, exposing the weaknesses and risks of involving heavy expert judgment in submitting quotes for LIBOR calculations.

- **Doubtful long-term sustainability:** Since the financial crisis in 2008, concerns about counterparty credit risk and more stringing liquidity requirements (e.g. the liquidity coverage ratio) has dampened borrowing and lending activities in the unsecured interbank money market. Without sufficient transaction data, LIBOR submissions have become more reliant on the expert judgement of panel banks. Therefore, regulators and panel banks are increasingly concerned about the representativeness of LIBOR. With wide support from the panel banks, the FCA announced that LIBOR would only be sustained till the end of 2021.

What are the alternative reference rates?

Currency	USD	EUR	GBP	CHF	JPY
ARR	Secured Overnight Financing Rate (SOFR)	Euro Short-Term Rate (€STR)	Reformed Sterling Overnight Index Average (SONIA)	Swiss Average Rate Overnight (SARON)	Tokyo Overnight Average Rate (TONAR)
Secured vs unsecure	Secured	Unsecured	Unsecured	Secured	Unsecured
Underlying transactions	Repo Transactions	Money Markets	Money Markets	Repo Transactions	Money Markets
Administrator	Federal Reserve Bank of NY	European Central Bank	Bank of England	SIX Swiss Exchange	Bank of Japan
Working group	Alternative Reference Rate Committee	Working Group on Risk-Free Reference Rates for the Euro Area	Working Group on Sterling Risk-Free Reference Rates	The National Working Group on CHF Reference Rates	Study Group on Risk-Free Reference Rate
Publication date	3 Apr 2018	2 Oct 2019	23 Apr 2018	25 Aug 2009	4 Jan 2017

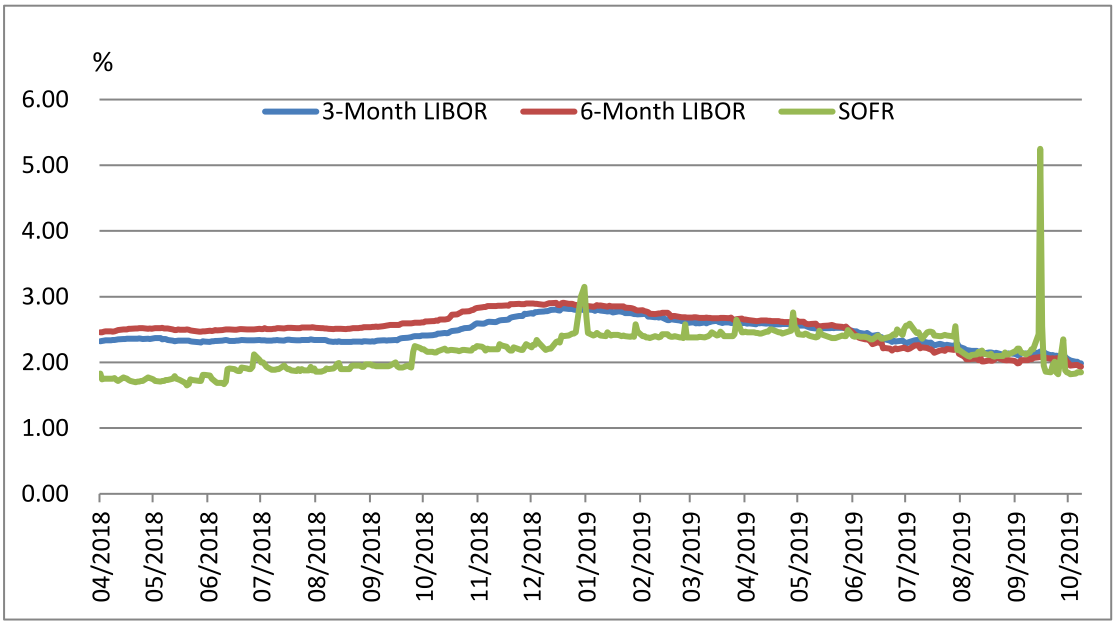
(Side note: In Hong Kong, a multiple rate approach has been adopted. While HONIA serves as an alternative to HIBOR, the two rates will co-exist and market participants are free to choose between them.)

What are the differences between LIBOR and ARRs?

LIBORs and ARRs differ in a number of ways:

LIBOR	ARRs
Various maturities, ranging from overnight to 12 months	Overnight only
Based on submissions from 11-16 panel banks	Based on actual historic transactions
Published on the same business day	Mostly published on the following business day
Credit risk premium is built-in	Minimal credit risk

SOFR tracked the 3-Month and 6-Month USD LIBOR but was relatively lower during most of the time, reflecting the absence of term premium and credit risk spread. However, SOFR appeared to be more volatile and occasionally higher than the two LIBORs, which are typical characteristics of overnight rates[2].



Source: Bloomberg, as of 11 Oct 2019

In order to transition the legacy contracts referencing LIBORs to ARRs,

[2] Regarding the detailed characteristics of SOFR, ARRC issued a User's Guide to SOFR. Found at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users_Guide_to_SOFR.pdf

adjustments for the term and credit differences have to be applied to the ARRs. Industry working groups have been set up in different jurisdictions to raise market awareness of the LIBOR cessation and facilitate the transition. For instance, there are the Alternative Reference Rate Committee in the US and the Working Group on Alternative Reference Rates in Hong Kong.

How can businesses prepare for the transition?

- Pay attention to the developments related to LIBOR transition.
- Understand how LIBOR is embedded in financial products and services and identify all the contracts with reference to LIBOR.
- Assess what kind of risks may arise from the transition and then formulate a transition plan.
- Try to avoid entering into new LIBOR transactions or rolling over existing ones. Otherwise, make sure there are fallback provisions in the contracts that will mature beyond the end of 2021.
- Seek professional advice regarding financial, legal, accountancy or tax issues if needed.

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