MONOCLE

IBOR TRANSITION

Addressing USD LIBOR and JIBAR

Monocle Research Team

2021

On 5 March 2021, the Intercontinental Exchange Benchmark Administration and the UK's Financial Conduct Authority (FCA) formally confirmed the dates for which the London Interbank Offered Rates (LIBOR) would cease and no longer remain representative – 31 December 2021. This announcement has removed any doubt amongst financial institutions (FIs) that the LIBOR transition – that underpins around $300 trillion worth of loans and derivatives – might be delayed.

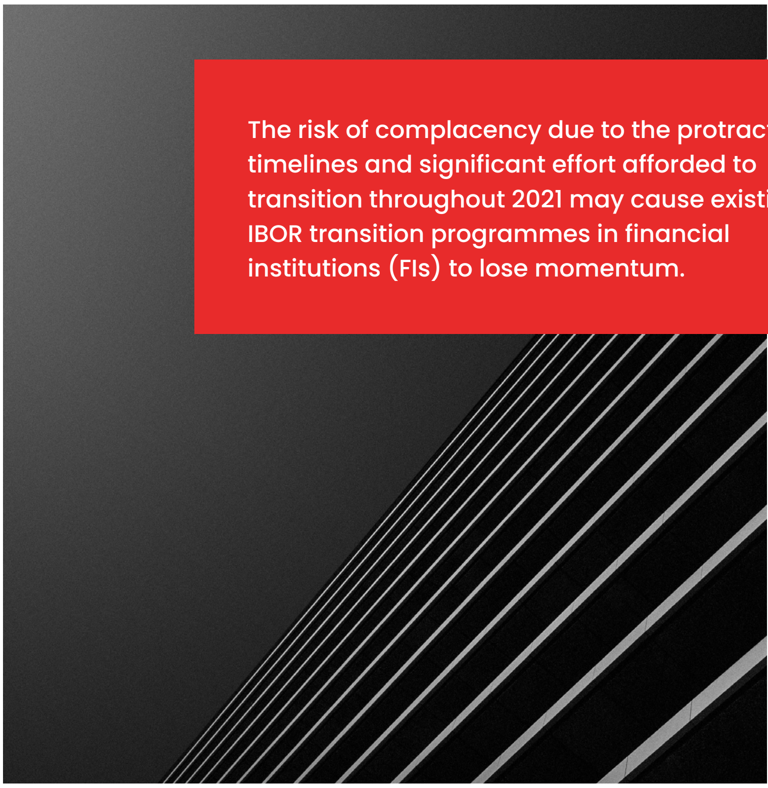
However, certain USD LIBOR tenors will continue through to June 2023, while in South Africa, its own IBOR rate, the Johannesburg Interbank Average Rate (JIBAR), is set to be replaced but has no confirmed transition date as yet. The risk of complacency due to the protracted timelines and significant effort afforded to transition throughout 2021 may cause existing IBOR transition programmes in FIs to lose momentum. This may prove costly, however, given that the scale and complexity of these operational and technical challenges in transitioning are not to be underestimated.

In this paper, we examine the lessons learned as financial institutions ramped up their transition programmes throughout 2021 and consider how they should address the transition of the remaining USD LIBOR and JIBAR tenor rates going forward.

USD LIBOR AND JIBAR TRANSITION

Even after being reformed in 2014, regulators were concerned that LIBOR lacked an active underlying market and continued to remain inadequate and unreliable as a benchmark rate. Regulators have found their replacement in various overnight risk-free (or near risk-free) rates measured from transactions in overnight secured and unsecured lending markets. These rates are considered more robust and predictable due to being anchored in more active and liquid markets.

The USD LIBOR settings, including the overnight 1-month, 3-month, 6-month and 12-month tenor will cease representation by **30 June 2023**. Due to the significant use of USD LIBOR globally, these USD LIBOR tenors were extended past the December 2021 deadline in order to allow legacy contracts to mature and ease the future transitional burden. By June 2023, roughly two thirds of all USD exposures in assets and derivatives will have matured. Importantly, USD LIBOR is being replaced by the secured overnight financial rate (SOFR) – a broad Treasury repo financing rate administered by the Federal Reserve Bank of New York.



The risk of complacency due to the protracted timelines and significant effort afforded to transition throughout 2021 may cause existing IBOR transition programmes in financial institutions (FIs) to lose momentum.

In contrast, the South African Reserve Bank (SARB) has confirmed that JIBAR will cease at some point in the future but has **yet to confirm the deadline**, as well as the replacement risk-free rate. With the statement of intent to transition in the future, banks must consider the consequences of writing further business that reference JIBAR and how to manage the transition to the unconfirmed RFR.

While significant progress has been made across both derivative and loan LIBOR transition programmes with most FIs well underway with their transitional plans, a loss of momentum across the IBOR transition programme following the 2021 deadline may impact an efficient transition for future rates. Considering this, Monocle has distilled our lessons learnt and what FIs will need to focus on to efficiently complete their USD LIBOR and JIBAR transitions.

IBOR SETTING	CURRENT CESSATION DEADLINE
Non-USD LIBOR – all tenors	31 December 2021
USD LIBOR – 1-week and 2-month tenors	31 December 2021
USD LIBOR – Overnight; 1-, 3-, 6-, 12-month tenors	30 June 2023
JIBAR – all tenors	To Be Confirmed by SARB

SYSTEM AND PROCESS IMPLICATIONS

The transition to RFRs does not allow for a like for like replacement. The use of historical transition data through backwards-looking reference rates is fundamentally different to forward-looking LIBOR and JIBAR rates – a difference which has resulted in substantial modifications for IBOR linked products, systems and processes. These updates are technically intensive and FIs that tackle these sooner rather than later will benefit by identifying their gaps and understanding the impact.

> The Financial Stability Board highlighted in June 2021 that 100% of global jurisdiction, including South Africa, had identified their LIBOR-referencing contracts and assessed the infrastructural and operational impact. [1]

While FIs are well underway, with their infrastructure modifications having identified the impacts of LIBOR transition, USD LIBOR and JIBAR specific system and process amendments should continue to be identified, catalogued and actioned with programmes considering the following:

- FIs must account for the challenges of *pulling these new rates from official sources as well as constructed curves* and must be integrated to feed into downstream systems and processes on a daily basis, including data models, calculation engines, pricing models and cashflow projections to name a few.
- *Specifically, trade and loan booking systems will require daily interest calculation updates* with the new RFR methodologies. These updates are often built from the ground up and must accommodate various compounding methods (such as compounding the balance, rate or using simple interest) as well as being able to book a loan with or without an observation shift. Considerations must also be made for lag days, lockout days, as well as credit spread adjustments, pricing and client margin.
- Following this, *Treasury must adapt their risk management capabilities* specifically for liquidity and market risk management and capital modelling. *Asset and liability reporting* needs to be able to accept the new rates and calculate the updated cashflows used in the calculation of ALM metrics.
- *Finance must consider the accounting and reporting impact* of RFRs following amendments to IFRS including the effect of IFRS 9's modification due to a change in cashflows, as well as the treatment of modification gain or loss as well as disclosure regarding the benchmark reforms as part of IFRS 7 – Financial Instruments: Disclosures.
- Operation teams will also need to *revise their invoicing and interest calculation process* due to the industry standard of a 5-day lag. While LIBOR rates were known in advance, interest through RFRs using a lagged methodology means that the interest period ends 5 business days before interest can be calculated and invoiced in the client. The methodology, combined with the varying RFR publishing times, as well as global time zones differences, requires an incredibly robust operational process.
- As previously mentioned, USD LIBOR will be replaced by SOFR while the JIBAR alternative has yet to be confirmed. FIs must, however, remain *actively engaged regarding industry decisions*, since ARRC recently endorsed the use of forward-looking SOFR term rates for USD LIBOR

1. FSB. (2021). Progress Report to the G20 on LIBOR Transition Issues. Available at: https://www.fsb.org/2021/07/progress-report-to-the-g20-on-libor-transition-issues-recent-developments-supervisory-issues-and-next-steps/

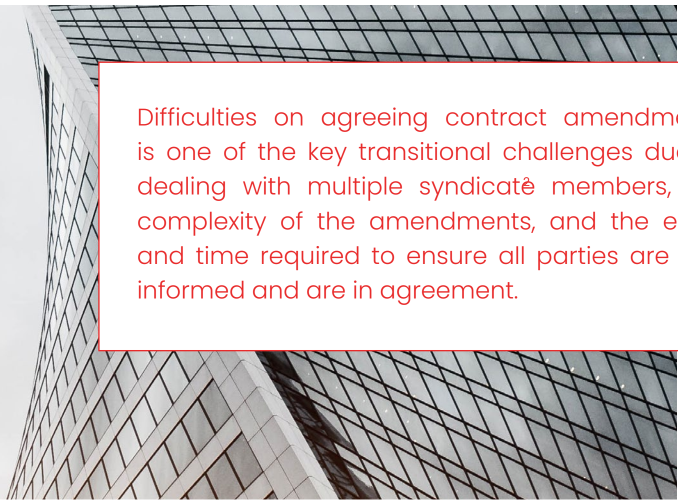
transition based on SOFR futures. This provides the opportunity for a like-for-like swap of rates, allowing FIs to operate similarly to how they did with LIBOR.

EXPOSURE ANALYSIS AND SINGLE VIEW OF CUSTOMER

A significant element of IBOR transition is the task of identifying and consolidating an *IBOR exposure inventory* across the various products subsets and booking systems within the institution. This foundational task is arduous but provides FIs with a consolidated view of their LIBOR exposures on a customer basis and the scope of their transitional programme.

By producing a *single view of a customer's LIBOR contracts*, legal teams can minimise the numbers of engagements with the client and syndicate members, as well as ensure that negotiation sessions are comprehensive and structured. Furthermore, it effectively supports tasks such as fallback language identification across LIBOR-indexed contracts, maturity analysis, as well as client communication and contract renegotiation.

Legal teams are then assigned the complex task of ensuring existing contracts are amended to include the *appropriate fallback language* (contractual terms relating to the replacement rate that would apply if the relevant benchmark became unavailable). Critically, legal teams will *negotiate the voluntary transition of existing agreements with clients*, as well as updates to the terms of the contract, including how new RFR calculation methods will impact the existing contracts and deals such as lag days, credit adjustment spreads, and compound methods.



Difficulties on agreeing contract amendments is one of the key transitional challenges due to dealing with multiple syndicate[2] members, the complexity of the amendments, and the effort and time required to ensure all parties are well informed and are in agreement.

The strength of an FI's client education and communication during this process is crucial, particularly for clients who may not understand the methodologies behind the RFR calculations. A single view of a customer will minimise conduct risk through repeated meetings and convoluted negotiations, as well as streamlining client engagement.

The extended deadline provides compliance teams with additional time to prepare, and by maintaining a consolidated record of IBOR-index loans and derivatives across the organisation, FIs are better enabled to manage effective client negotiations.

NEW CONTRACT CONSIDERATIONS

The continuation of USD LIBOR representation is not meant to support new LIBOR activity with American regulators, recommending that any new contracts should *make use of the alternative reference rates as soon as practically possible*. In this way, FIs will be able to avoid any complex renegotiations and modifications as the 2023 deadline approaches.

From a JIBAR perspective, no alternative rate has been announced, which prevents a hardwired approach to fallback language whereby FIs include backstop fallback terms connected to the dedicated RFR (such as SONIA for GBP LIBOR or SOFR for USD LIBOR). In anticipation of the alternative rate, FIs can take an amendment approach. FI's can make use of *screen rate replacement event mechanisms* in future contracts, which provides additional flexibility and lowered consent thresholds in order to amend contracts at the appropriate time in the future – following a trigger event like JIBAR cessation. This approach would set certain parameters regarding the contract amendments required following a trigger event. This includes amendments to finance documents, interest calculations, market conventions, fallback language and changes in pricing. Screen rate replacement events or triggers would also be defined that would initiate the request for amendment to transition to the, as yet unannounced, RFR benchmark that will replace JIBAR.

2. Ibid

HOW MONOCLE CAN ASSIST

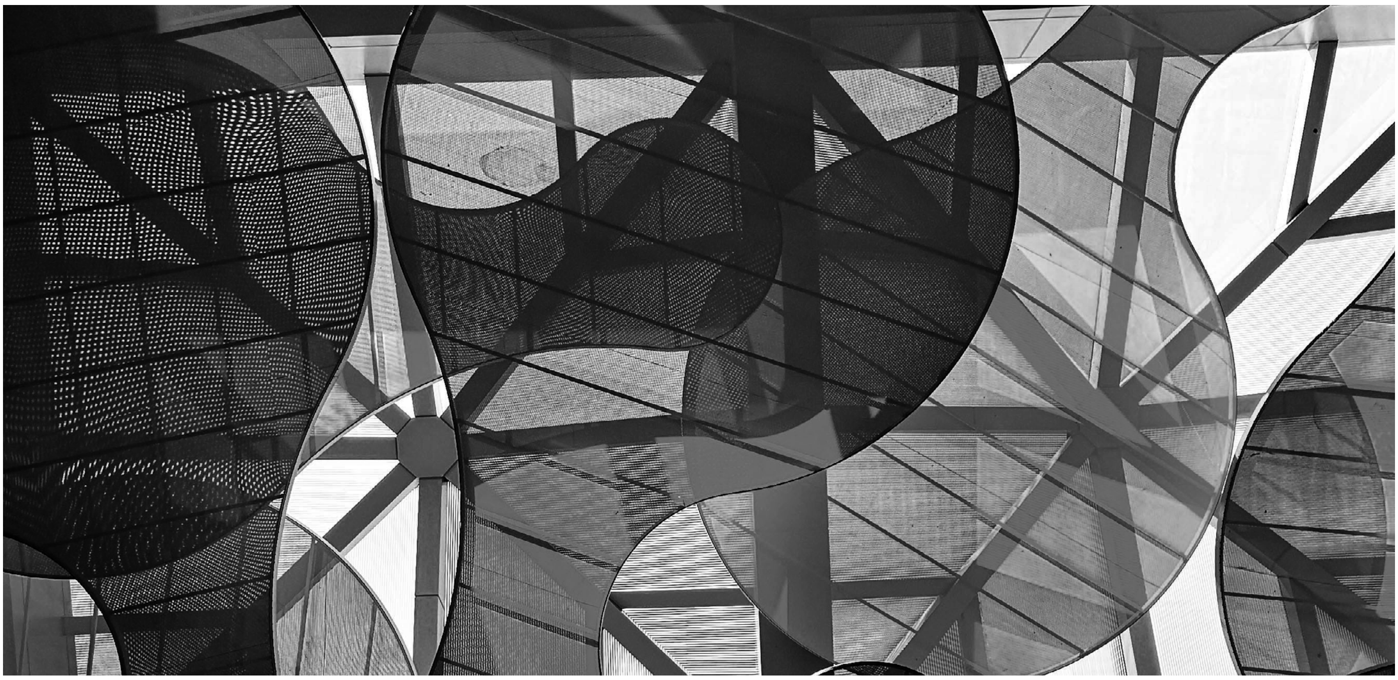
Over the past several years since FIs began to prepare for the transition away from LIBOR, Monocle has been actively involved across the banking functional value chain to help prepare for this change. We have expertise across trade management, treasury, finance, front office risk and pricing, as well as system and data infrastructure analysis. Our reference rate transition experience includes:

- Operational system design and build to enable the sourcing of RFRs, as well as the calculation of interest for trading and loan platforms through Monocle-built interest models (SQL).
- Legal contract analysis focused on flagging fallback rate clauses.
- Developing a single view of customer capability to provide effective contract negotiations by identifying any and all relevant contracts ahead of time.
- Data analysis of all loan and derivative securities to facilitate exposure analysis reporting, transition progress reporting, as well as ad hoc regulatory reporting (IBOR transition SARB report).
- Advisory services around rate reset dates, interest methodologies, and other transitional process and data issues.

ABOUT MONOCLE

Monocle is a management consulting firm specialising in banking and insurance. Since 2002, we have assisted industry-leading banks and insurance companies around the world, including institutions in the United Kingdom, Europe, Scandinavia, Asia, South Africa and throughout sub-Saharan Africa.

We design and execute bespoke change projects from start to finish, bridging the divide between business stakeholders' needs and the complex systems, processes and data that sit under the hood. We offer several unique capabilities to our clients, which have been forged over time through the combination of a highly specialised skillset and extensive experience working with the systems, processes and people that are at the heart of the financial services industry.



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