Focus on Building RFR Liquidity – It’s Time to Leave LIBOR Behind

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The LIBOR reference rate is firmly on the road to retirement, and the last day of service as we know it is slated for December 31, 2021. The LIBOR transition is expected to impact contracts worth over $350 trillion. Some financial institutions are already hard at work repapering contracts to remove LIBOR references, replacing LIBOR rates with alternative reference rates (RFR) such as SONIA and SOFR in all future contracts. Others are delaying this process, optimistically awaiting delivery on the promise of alternative, forward-looking term RFRs made by regulator backed working groups, as suggested by Andrew Bailey, Governor of Bank of England and former Chief Executive of the FCA.

There is certainly a lot of activity toward finding alternatives to LIBOR. The ARRC is a working group organized by the Federal Reserve to support the transition away from LIBOR. In its “2020 Objectives” document, ARRC cites the establishment of a forward-looking term SOFR rate as its number one objective for the first half of 2021.[1]

Bailey made the following remarks in his “LIBOR: Preparing for the end” speech given in July of last year[2]: “One reason that loan markets have been relatively slow to move may be the way that forward-looking term rates are embedded in practice and systems. Some may have persuaded themselves to wait until forward-looking term versions of SONIA or SOFR can be produced.”

To a large extent, the release and ultimate use of forward-looking RFR term rates, would likely mean in house systems and technologies would not require an overhaul to enable calculation of RFRs in their standard form. However, due to the typically backward-looking nature of RFRs, converting them to forward-looking equivalents will mean that a firm's internal and third-party systems, where LIBOR is embedded and used for various calculations, will require substantial upgrades. In many cases, rigorous testing will also be required to meet regulators' stringent standards of robustness.

LIBOR is used globally as a benchmark reference rate. It is calculated over seven different tenors, in respect of five different currencies. LIBOR is used in derivatives markets, loans, bonds, mortgages and generally as an indicator of liquidity during times of market volatility. In-house systems are currently designed to calculate according to LIBOR's forward-looking nature. A forward-looking term RFR would closely resemble LIBOR by producing forward-looking interest periods. This would give the market the up-front certainty it requires, the interest rate for an interest period being known at the beginning of an interest period.

The LIBOR benchmark is calculated with input data received from a panel of between 11 to 16 contributor banks. The methodology used to determine each panel bank's input data is structured as a waterfall, across 3 levels, the last of which is the use of the bank's 'expert judgement'. Since 2013, banks have largely relied upon the repo market to provide their own funding requirements. As a result, overnight lending between banks is very rare. Therefore, expert judgement is heavily relied upon to determine a panel bank's input data.

RFRs on the other hand are considered to be far more robust than LIBOR because they are based on real transactions, directly referenced from actual overnight trade data. RFRs are largely provided by BNYM, derived from their repo market data. RFRs are seen to be largely risk free as they are anchored in actual overnight transactions. Therefore, RFRs are priced without the need for a credit risk premium, as is the case for LIBOR.

A true term RFR would give the market the upfront certainty it craves like LIBOR does. Since no true term RFR has presented itself so far, it's easy to understand why some entities have not yet committed to meaningful LIBOR transition planning. Those delaying their transitions away from LIBOR are trying to avoid the costly updates they'll need to make to systems and contracts. Clearly, they are hoping that true term RFRs are made available so they won't have to do this expensive work.

Financial institutions which are waiting for true term rates are well-advised to reconsider that choice. Bailey remarked in his "LIBOR: Preparing for the end" speech given in July of last year[3]. "…we think that any firms still delaying transition until term rates arrive are making a mistake."

Mr. Bailey recommended that the market should adopt the RFR compounded in arrears approach rather than wait for a true term RFR. He stated, "Indeed I think the prevailing view on our Risk Free Rate Working Group – the UK equivalent of the ARRC in the United States – is that overnight SONIA, compounded in arrears will and should become the norm in bilateral and syndicated loan markets too."

The key to RFRs becoming more predictable and palatable to financial institutions is liquidity in RFR markets. As RFRs are used more, their liquidity will grow which feeds their stability and as a result, LIBOR's liquidity will diminish. This creates a seesaw effect – for liquidity to rise in one, liquidity of the other must fall.

Bailey alluded to the importance of liquidity in RFRs (using e.g. SONIA and SOFR) as the driver for a forward looking RFR term rate, "The support that has been offered from banks in discussions to date in relation to term SONIA, makes us optimistic we will make good progress on its production. But I cannot guarantee that these efforts to produce term rates will be successful, or the precise timing of their arrival. That depends in part on ample supporting liquidity in SONIA and SOFR derivatives markets. That is a second reason we think that delaying transition until term rates arrive is mistaken."

The onset of RFR liquidity is crucial to the transition from LIBOR and more importantly, liquidity should be the catalyst for taking the plunge. Liquidity removes the uncertainty and creates stability in the RFR market. Once liquidity arrives for RFRs, a proverbial leap of faith from LIBOR will not be necessary as the stability which liquidity provides will be present.

To what extent is RFR liquidity being driven today? Amongst other things, we have seen the following three events come into play recently, driving burgeoning liquidity forward in the process.

1. ISDA IBOR Fallbacks Protocol:

Released by ISDA during the tail end of October this year, effective 25th January, 2021. The Protocol ships in RFR fallback wording to be used when LIBOR is no longer deemed available. The Protocol is implemented upon its effective date into the terms of all live transactions facing fellow, adhering parties. It may be used to address fallbacks referenced in a number of master agreements collectively and is brought into effect by way of express adherence by parties to a bilateral relationship. The main benefit of the Protocol is that it introduces a uniform, industry-wide fallback waterfall for each of the LIBOR related currency/tenor RFR fallbacks, serving to drive and bolster liquidity in these markets. A testament to its popularity to date, the number of adherers currently standing at 2771 and counting.[4]

2. CCP discounting switch "big bang":

Between the 16th and 19th October, 2020 the world's largest CCPs, LCH and CME conducted a big bang discounting switch from valuing the price alignment interest relating to interest rate based swap and swaptions to SOFR from USD LIBOR. The value of the trades and liquidity as a result of the discounting switch from EFFR to SOFR at LCH alone amounted to a notional $120 trillion thus further working to establish liquidity in SOFR.

3. Regulator stipulated transition timings

Another driver of RFR liquidity is the release of regulator backed working group transition timelines, adopted by regulators as a series of milestones. The Bank of England in its Sterling working group's UK RFR Roadmap document[5] lays out dates in which various LIBOR currency/tenor combinations may no longer be entered into, replaced by respective RFRs in each case. In a recent LinkedIn post the Sterling working group indicated that GBP LIBOR linked linear derivatives, other than for risk management purposes, are to cease by the end of Q1.

The writing on the wall says that LIBOR must be replaced with RFRs. All the above further strengthen the case for the existence of RFR liquidity in the market and the time for transition is now. The LIBOR cessation date therefore should be viewed as the day its sun will set. However, LIBOR is already firmly in its twilight and its replacement is no longer a distant glow. The true barometer for change lies in RFR liquidity and the time to strike is now.

According to the 2020 Integreon Regulatory Readiness Report released in September, just over half of corporations (51%) believe they are well prepared for the LIBOR transition. Though it's encouraging that many companies have already prepared for LIBOR, this still leaves nearly half which have not tackled it yet.

Having a solid LIBOR transition strategy, with clearly defined timelines and goals, is essential to producing a successful result. The absence of a transition strategy for LIBOR increases the risk of economic, legal and reputational damage. To ensure a safe and smooth transition to RFR from LIBOR, four major steps must take place.

1. **Discovery**
   Identify documentation that must be transitioned and evaluate associated risk to the organization. This includes determining criteria needed to assess risk and exposure. Once the full extent of applicable contracts and clauses containing LIBOR has been sized up, the filtration and prioritization process can begin.

- Ensure that all contracts have been digitalised via OCR, including related amendment agreements and ancillary documents, to determine the LIBOR in-scope population.
- All contracts should then be saved in a location which will serve as a golden source. It may be necessary to limit access by certain groups, for example the protection of data relating to coded accounts from Front Office, etc.
- Ensure that linked agreements, for example hedging and syndicated loan pairings, are identified and collated.

2. **Prioritization**
   Determine transition activities based on assessed risk and economic exposure, prioritizing contracts for remediation and "repapering". The entire project's scope should become clear by the end of this step.

   Once Discovery is complete, technology can be employed to analyse all contracts and determine the LIBOR in-scope population. An example of LIBOR clauses includes those related to margin, interest payments and default interest in relation to hardwired and fallback provisions.

3. **Solutioning**
   Develop a project roadmap with well-defined metrics and milestones, perhaps in the form of a playbook that can guide the LIBOR transition and repapering process. The solution stage is an ideal time to determine which additional resources are necessary for completion of the plan.

- Bilateral repapering. Amendment templates should be created for each agreement type for wholesale repapering. Among other things, these templates should address consequential amending. Structures of different contract types vary across their clauses. The knock-on effect of remediating LIBOR in relation to the remainder of the agreement should form part of the repapering approach. For older relationships, there may also be a need to update terms to current house standard to eliminate legacy basis risk.

- Tough legacy scenarios aside, where replacement wording is required (notwithstanding economic provisions), it will likely take the form of (1) an immediate or other pre-cessation date trigger or (2) wording triggered upon or before cessation. A decision will need to be taken in each case, informed by the desired economic outcome and alignment with system readiness. In each case, clause amendment wording will need to be carefully considered in order to accurately implement all desired outcomes.
- Protocol adherence: An amending opportunity arises for largely “vanilla” LIBOR fallback amends by way of industry led protocol solutions, for example ISDA’s IBOR Fallback Protocol. Protocols do have their uses but are somewhat limited in scope. Their appropriateness should be considered on a case-by-case basis and generally their usage will form only part of a repapering solution.

4. **Delivery**
   Execute the plan and track to ensure all milestones and project objectives are achieved. This typically includes renegotiation and repapering for both standard and complex legal agreements.

Whether an organization is on the buy side, sell side or is a non-financial entity, LIBOR cessation will have a pronounced impact when it finally does occur. Due to the pervasive nature of LIBOR as a benchmark, companies are best served by starting the phase-out process now, even if a true term RFR is not yet available. Entities which fail to prepare for LIBOR cessation are headed for trouble with regulators. They stand to be exposed to a litany of potential complaints and even litigation.

Whatever the outcome is for regulatory change to come, it’s certain that LIBOR’s days are numbered and the time to act is now.

About the Author

Dean Nasser is VP | Contracts, Compliance & Commercial Services at Integreon, an alternative legal services provider. Dean supports the Business Development unit with the provision of regulatory subject matter expertise. Dean has over 15 years of legal financial services and regulatory experience, gained from a mix of working for and consulting at tier 1 sell-side entities, mostly related to financial markets in the transactional space.

[1]The ARRC 2020 Objectives document. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_2020_Objectives.pdf

[2]LIBOR: preparing for the end. Speech given by Andrew Bailey on 15th July, 2019

[3]LIBOR: preparing for the end. Speech given by Andrew Bailey on 15th July, 2019

[4]ISDA List of Adhering Parties webpage: https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/adhering-parties

[5]UK RFR Roadmap | 2020-21 intermediate update. https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf?la=en&hash=92D95DFA056D7475CE395B64AA1F6A099DA6AC5D

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