Examining what's next for LIBOR:

Top themes dominating the transition in 2021

Liang Wu, Executive Director of Financial Engineering & Head of CrossAsset Product Management, Numerix

numerix

When numbers matter

Liang Wu
Executive Director of Financial Engineering & Head of CrossAsset Product Management, Numerix

We have spent a lot of time talking about the end of LIBOR and the transition to alternative reference rates (ARRs). Now, there is less than a year left before the expected cessation of this benchmark, with the exception of the most liquid USD LIBOR tenors being published until June 2023. While there is now more time for the transition of key USD LIBORs, the IBORs of other major currencies appear to be on schedule for their discontinuation at year-end.

Globally, much transition progress has already been made. Trading volumes in the major risk-free rates (RFRs) are gaining momentum, with volumes in SONIA being particularly strong, and the markets anticipate seeing an even greater liquidity shift from LIBOR to RFRs this year. At the same time, jurisdictions in the Asia Pacific region have made solid advances in supporting their transitions away from LIBOR, such as, in most cases, by identifying appropriate ARRs for their local currency IBORs. Furthermore, in Singapore, new products are being developed that reference its replacement benchmark, SORA (Singapore Overnight Rate Average). Arguably, the most significant latest development is that the ISDA IBOR Fallbacks Supplement and Protocol for new and legacy derivatives contracts is now effective, and regulators and industry committees have stepped up their communications to market participants regarding the need to transition away from LIBOR as soon as possible.

Supporting the notion that "there is not much time left," in a significant communication released by the Financial Conduct Authority (FCA) in early March 2021, the FCA confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative:

- Immediately after December 31, 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month U.S. dollar settings; and
- Immediately after June 30, 2023 in the case of the remaining U.S. dollar settings

So, it follows that all 35 LIBOR settings will either cease to be provided by any administrator or no longer representative after the dates set out above.

As progress in the LIBOR transition continues, there are several crucial issues market participants face in 2021. I have endeavored here to highlight what I view as five top market themes that deserve examination and to share my opinions as a financial engineer who has been deeply immersed in the decommission of LIBOR ever since the UK's Financial Conduct Authority announced in July 2017 that it will no longer compel banks to use LIBOR after the end of 2021.

Top 5 Themes Driving the LIBOR Transition in 2021

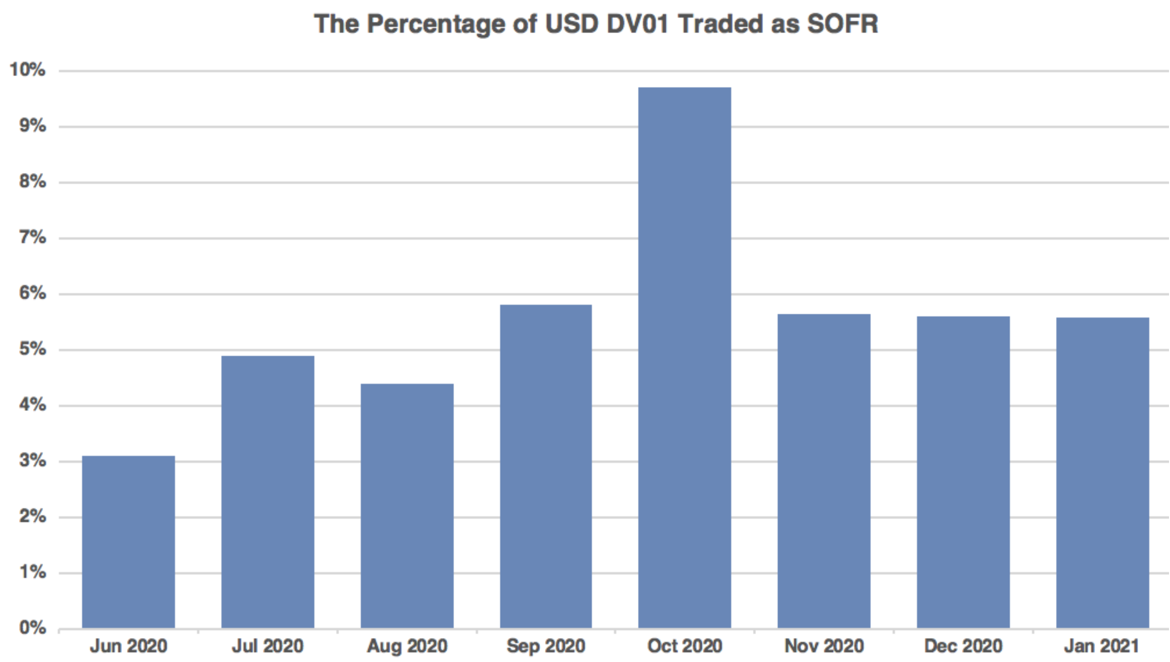
1. 2021 Is Not Really the End of LIBOR

On November 30, 2020, the Intercontinental Exchange (ICE) announced its plan to extend the proposed end date for most U.S. LIBOR tenors from December 31, 2021 to June 30, 2023. This proposal was then confirmed by the FCA on March 5, 2021. This reflects approximately an 18-month reprieve from the death of U.S. LIBOR.

I view this as a welcome extension. It allows market participants with legacy contracts that have longer maturity dates more time to properly prepare for the termination of U.S. LIBOR and to complete the LIBOR transition. Thus, it is helpful that institutions are not being forced to be 100% transitioned by the end of 2021. The majority of the longer-dated derivatives contracts will mature by the middle of 2023 anyway, so the extension is a good move that will benefit the market.

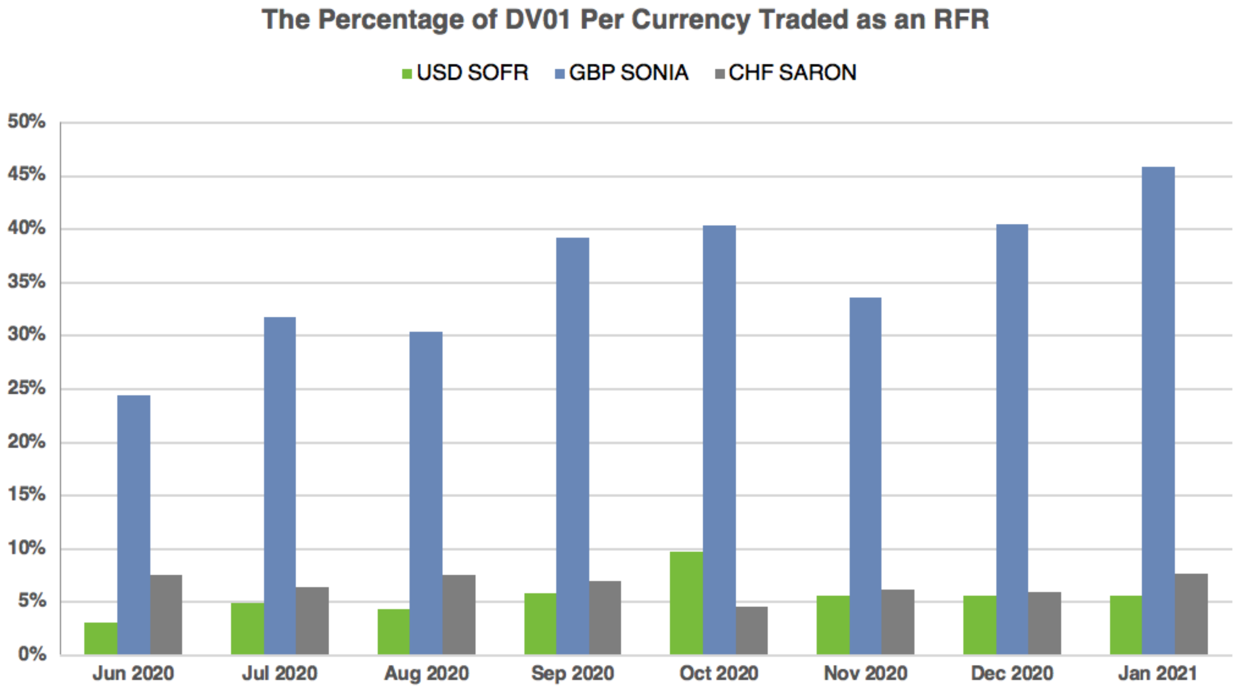
However, it must be acknowledged that SOFR trade volumes have been flat since regulators granted USD LIBOR the 18-month extension, with, according to a recent Risk.net article, traders blaming poor liquidity and the industry's reliance on new fallback language.

SOFR RISK TRANSACTIONS FLATLINE FOR THREE MONTHS IN A ROW



For three months running, 5.6% of total USD risk was transacted versus SOFR. (Source: Clarus Financial Technology).

SOFR RISK TRADED VERSUS OTHER BENCHMARKS



In comparison to SOFR, SONIA markets hit new highs in terms of percentage traded in SONIA—45.9% of all risk transacted was versus SONIA. CHF SARON markets reached 7.7%. (Source: Clarus Financial Technology).

What is very important, though, is that regulators are emphasizing that while there is this buffer period, market participants should not be under the impression that the 18-month extension means they can execute new trades of LIBOR-based derivatives until June 2023. While institutions can't be stopped from doing that, it would be very unpragmatic to enter new LIBOR trades versus using SOFR. It has to be very strongly messaged to market participants that the end of 2021 deadline still holds for new products. Now might be the time to reexamine if your firm has all of the curve analytics and models in place to handle the LIBOR transition, and beyond.

2. Looking Forward to a Forward-Looking SOFR Term Rate

The market has long anticipated a forward-looking SOFR term rate. However, according to the Alternative Reference Rate Committee's (ARRC) latest progress report, a term SOFR rate is unlikely to be published in 2021. Does this change things for market participants?

SOFR does not currently allow for predictive, forward-looking rate calculations—3, 6 or 12 months out—which is a deviation from LIBOR. While a SOFR compounded-in-advance-rate offers an alternative, I believe a term SOFR rate could be quite useful to the market. It is also worth noting that while the first forward looking term rates based on SONIA have been available since January 2021, ARRC acknowledged that the flat liquidity of short-dated SOFR derivatives contracts has made it difficult to publish a term rate, and the market shouldn't anticipate one by mid-year or maybe even by end-of-year 2021.

> The availability of a forward-looking term structure for SOFR may be necessary to transition some cash products from USD LIBOR to SOFR to ensure certainty of cash flows.

Regarding SOFR, I want to add, however, that the LIBOR transition doesn't necessarily need to wait for a forward-looking term SOFR rate. You can argue that trading in the current derivatives market on SOFR has been picking up and is growing gradually, so from that perspective the derivatives market, as it is now, is not counting on a term rate. Nonetheless, I don't want to lessen the potential usefulness of a term rate, especially a forward-looking one, because it could be very important for certain contracts to be linked only with a forward-looking term rate in practice, instead of some other form of the overnight rate. It would be extremely helpful because a forward-looking term rate would be very much like the current LIBOR and could ease the transition for products similar to LIBOR-based products.

For example, availability of a forward-looking term structure for SOFR may be necessary to transition some cash products from USD LIBOR to SOFR to ensure certainty of cash flows in the beginning of each payment period.

3. IBOR Fallbacks: Having Curve Analytics and Models at the Ready

On January 25, 2021, the International Swaps and Derivatives Association (ISDA) announced that new fallbacks for derivatives linked to key IBORs were now in effect. On March 5, 2021, ISDA also confirmed that the spread adjustments to be used in its LIBOR fallbacks will be fixed as of that March date, which provides clarity on the future terms of derivative contracts that will incorporate these fallbacks. These announcements ease a good amount of transition risk for the market. However, they may also present a technology hurdle to market participants that have yet to address the modeling challenges and technicalities of fallbacks.

The core issue is now that the spreads are permanently fixed for the IBORs, market participants will need to take those as inputs to comply with the ISDA IBOR fallback methodology in their derivatives valuations. This is attracting a lot of attention because this means market participants will have to pursue technology upgrades or even consider transitioning their internal systems to make sure their fallback mechanisms can be triggered now that the fixed spread adjustments are effective.

This presents another issue, which is when institutions plan to execute system or analytics upgrades. Now that the spread rates are fixed, institutions need to quickly handle their current legacy contracts to make sure fallback mechanisms can kick in before the end of 2021. I feel this provides a sense of urgency in regard to having transition upgrades in place. Taking the first steps now to ensure you have the correct curve framework will ensure a much smoother and seamless transition to handle not only vanilla products but non-linear derivatives as they come into play.

According to a Barclays study published in 2020, nearly 60% of respondents saw ISDA's fallbacks as the most important mechanism for transitioning away from LIBOR-linked instruments.

Source: Risk.net; February 2021

4. Keeping an Eye on Cross-Currency Markets Volume in 2021

The cross-currency markets have yet to embrace SOFR. At the end of 2020, there were small amounts of trading volumes. Could 2021 be the year when there is a big boost in trading in the cross-currency markets as SOFR becomes more established as a standard RFR?

Trading volumes for cross-currency markets is trending upward and I believe we will see the further development of the cross-currency markets between different ARRs, such as SOFR vs. SONIA, SOFR vs. €STR, and SOFR vs. TONAR. Currently, cross-currency trading using SOFR is a fairly empty market, but I anticipate this market will grow in the year

2021. However, just like we can't predict the growth rate in the SOFR market alone, we can't predict the rate at which the cross-currency markets on SOFR will grow.

Typically, there are two major types of trades, one is between developed market currencies, where basis swaps are generally traded, and the other is between emerging markets and developed markets, which normally trade cross currency swaps.

I want to note that the cross-currency swap markets really have yet to embrace risk-free rates (RFRs), such as SOFR and €STR, while SONIA may be in a stronger position because its volume is larger than that of GBP LIBOR in the sterling market. However, despite the slow movement, I am optimistic the cross-currency markets will move to using RFRs for cross currency swaps and that it will become a market standard by 2022.

5. Exploring a Market Need for a Credit Sensitive Alternative to SOFR

There is demand in the U.S., particularly from regional banks, for a credit sensitive rate that is an alternative to SOFR. A big question among market experts is whether the derivatives market needs a credit sensitive rate.

If we are just talking about the derivatives market alone, the prevailing view is that a credit sensitive rate is not necessarily needed. One overnight rate (SOFR) that is close to the risk-free rate is good enough because in situations where either a new contract is directly linked to SOFR or an existing contract is managed according to the ISDA IBOR fallback—basically a compounded SOFR rate plus a static spread—you can always hedge the volatility of the SOFR rate dynamic without introducing the credit component. So, if we're just talking about hedging the SOFR risk out of a portfolio using SOFR derivatives as they are now, that is sufficient, and you don't need the credit premium aspect.

In terms of the cash market, if it is operating under the assumption that future issuance will be based on a SOFR rate plus a static spread, then you don't have the need for a credit-linked SOFR rate. However, if there is a need to mimic a LIBOR-like product in the future issuance of cash products, then that is a problem because SOFR doesn't have a credit component, but LIBOR does. So, from that perspective, if you want to identically mimic your current business by just switching to a different rate, that might be a complication.

This presents two issues. One is to create a variation of the SOFR rate so that it has dynamic credit information within it, and the other is to create a completely alternative rate that has a credit component but is not a SOFR rate. In terms of the latter, it already exists.

Ameribor is a credit sensitive alternative rate to SOFR. While the big banks and the clearing houses all switched to SOFR, some smaller, regional banks still value having a credit-linked rate for conducting their type of business. So, I can see Ameribor having its own market that is independent from SOFR. The existence of an Ameribor market may not present any drawback to the SOFR market, at least for now. Both rates are growing and market participants have interest in both of them. Of course, SOFR is still going to be the dominant rate. However, if there is a need for people to look for something non-SOFR, there is Ameribor.

Address Your LIBOR Transition with Numerix CrossAsset

Numerix is helping its clients accelerate their LIBOR transition and respond to the impacts of an alternative reference rate landscape by offering a comprehensive suite of market-leading analytics, ARR curve coverage and other portfolio solutions. To speak with an expert about your LIBOR transition needs, please contact us at: sales@numerix.com

ABOUT THE AUTHOR

Liang Wu is an Executive Director of Financial Engineering and heads up CrossAsset Product Management at Numerix. Wu has previously served as VP of Financial Engineering in the Client Solution Group at Numerix. Before joining Numerix in 2015, he worked at CME Group and HSBC in Pricing and Valuation, and Model Review roles. He holds an MSc degree in Financial Engineering from Columbia University, an MSc degree in Space Physics from Rice University and a BSc degree in Geophysics from University of Science and Technology of China.

Ready to elevate your business?

Get started →

More than 550 clients and 90 partners across 52 countries rely on Numerix analytics. Headquartered in the financial capital of the world, with offices around the globe, Numerix brings together unparalleled expertise combined with local market understanding.

Numerix LLC Corporate Headquarters

100 Park Avenue
15th Floor
New York, NY 10017
Tel: +1.212.302.2220
Fax: +1.212.302.6934
www.numerix.com