The 5 top-of-mind issues dominating the LIBOR transition

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When numbers matter

There are many questions related to the transition from LIBOR. How could there not be considering that replacing the decades-old benchmark rate could turn out to be one of the most profound developments in financial markets for many years to come, and certainly will hold a place in financial history. With around $350 trillion worth of financial assets tied to LIBOR, it has provided a consistent way to determine the cost of everything from student loans and mortgages to complex derivatives. With little reason to think the transition to alternative reference rates will be a straightforward process, I address what I think are the 5 top-of-mind issues facing market participants.

1. Is time running out? A successful transition from LIBOR depends on how fast the market is willing to move.

We have already seen a significant step forward in that the identification of the replacement rates for all five LIBORs is complete. But the answer to the above question depends on the specific currency. Moving to a new reference rate requires market liquidity, and one of the practical challenges of a transition from LIBOR is liquidity in instruments based on the new rates and the timing of the transition for each currency—and the sooner things are set in motion, the lower the execution risk. So let's look at the situation regarding all five LIBOR replacement rates.

In June 2017, the U.S., the Federal Reserve Bank of New York and the U.S. Treasury Department introduced SOFR (Secured Overnight Financing Rate) as a replacement to U.S. LIBOR, and in April 2017 the Bank of England selected Reformed SONIA (the Sterling Over Night Index Average) as the alternative to LIBOR. The working committees for both currencies have created comprehensive transition plans and liquidity is building for new products that reference these rates. SONIA is in the best shape as SONIA-based derivatives contracts are already well established. For example, as of August 2017, derivative contracts worth 7.7 trillion pounds have been priced against SONIA (but mainly short-term contracts).[1]

In December 2016, the Bank of Japan selected TONAR (Tokyo Over-Night Average Rate) as the LIBOR replacement for the JPY, but liquidity momentum with derivatives contracts could use some support. In October of 2017, the Swiss National Bank, in cooperation with SIX Swiss Exchange, determined that SARON (the Swiss Average Rate Overnight) would replace LIBOR. Liquidity has been building for SARON.

However, only recently has ESTER (Euro Short-Term Rate) been identified as the alternative reference rate for the euro. The delay in the selection of ESTER could compress the timeline for a full and successful transition away from LIBOR for the euro.

The core challenge of the transition from LIBOR is the level of market adoption for new products that are tied to the new alternative reference rates.

Selection of LIBOR Alternative Reference Rates Complete

Currency	Rate	Date of Selection
JPY	TONAR (the Tokyo Over-Night Average Rate is the uncollateralized overnight call rate, which is calculated and published by the Bank of Japan as the JPY risk-free rate)	December 2016
GBP	Reformed SONIA (the Sterling Over Night Index Average is the interest rate bench-mark that reflects bank and building societies' overnight funding rates in the sterling unsecured market)	April 2017
USD	SOFR (the Secured Overnight Financing Rate is a new, broad Treasury repo rate)	June 2017
CHF	SARON (the Swiss Average Rate Overnight is based on data from the Swiss franc repo market)	October 2017
EUR	ESTER (Euro Short-Term Rate for the euro interbank market)	September 2018

1) Source: Reuters

2. Liquidity momentum: Adoption of new products and adequate liquidity.

Without any doubt, the core challenge is the level of market adoption for new products that are tied to the new alternative reference rates. The reason being that liquidity will be considered the single most important qualification for the adoption of alternative rates. In that regard, a successful transition away from LIBOR would necessitate a sufficient level of liquidity for these products.

The market will ultimately determine the pace of adoption; however, we already see some positive liquidity signs. For example, SOFR has built significant momentum with CME SOFR Futures reaching $711Bn in cumulative notional volume based on 278,000 contracts[2], representative of the large liquid market that exists in futures. Additionally, there is already a well-established volume in SONIA swaps.[3]

3. Renegotiation of legacy contracts.

For existing contracts that reference LIBOR and mature after 2021, market participants should examine the documentation to identify any fallback provisions that are included in the event that LIBOR is unavailable (and whether those provisions are sufficiently suitable or practical). If a LIBOR substitute is not expressly incorporated in a contract, try to get the contract amended. Following the anticipated end of published LIBOR after 2021, legacy instruments lacking fallbacks may be subject to considerable uncertainty.

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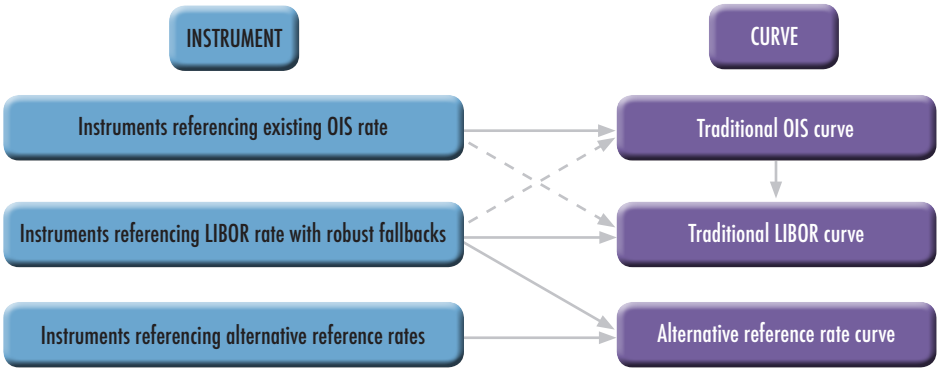
For derivatives transactions being entered into between now and 2021, it is important to incorporate provisions that will allow for a smooth transition from LIBOR to another reference rate in the future. As the markets evolves, we will see new contracts referencing alternative rates instead of LIBOR.

4. Curve construction implications.

As the market evolves, new curve construction approaches could emerge, so we need to look at some details concerning instruments and curve mapping.



Let's consider the above diagram. As of now, you can use your instruments that reference the existing OIS rate for traditional OIS curve construction. If you want to use the OIS basis instrument for OIS curve construction, you can do that as well. On the other hand, if you have LIBOR-based instruments, you can do the traditional LIBOR curve construction. Direct use of the OIS instruments or OIS basis instruments alongside the LIBOR instruments can construct

2] Source: CME Group
3] Source: Risk.net

a LIBOR curve and an OIS curve via global solving.

What's new is that if instruments referencing LIBOR start to include robust fallbacks, this provides the opportunity to use such instruments, as well as the fallbacks, to construct an alternative reference rate curve. If you have a new instrument directly referencing the alternative reference rate, you can construct the alternative rate curve.

Not everything is changing with the potential move away from LIBOR, though. For all IBOR's not under FCA regulation, there's no clear decision yet on the continuation of each of them, but if market participants need to reference current IBORs for curve construction, it should be done as needed.

Also, if there are curve adjustment features such as "central banks meeting schedule" and "turn effect," these should still be incorporated and the curve framework being used should support them. Cross-currency basis curves do not go away even if LIBOR is eventually phased out. Lastly, new curve frameworks should be very flexible, so if there is a new instrument that becomes very liquid, it can be implemented very quickly.

5. A world without LIBOR?

There are some who doubt that support for LIBOR will completely cease, thinking it unrealistic that it will just simply disappear after 2021. Given the sheer volume of derivatives contracts and debt currently tied to LIBOR, they may be right that removing LIBOR from the landscape will unlikely happen by 2021.

There is some doubt that support for LIBOR will completely cease, but it is widely believed that market participants should be prepared for a world without LIBOR.

However, it is more widely believed that market participants should be prepared for a world without LIBOR. The regulator of LIBOR, the FCA, made it very clear that panel banks need only sustain LIBOR by the end of 2021. After that, there is no regulatory requirement for panel banks to continue making LIBOR submissions, and it is entirely possible the banks will leave the panel when that point is reached, which consequently will make the existence of LIBOR essentially unfeasible.

Moreover, as new alternative reference rates are identified, if there is sufficient market adoption of new products, then it will help the market transition more quickly to the new rates and decrease dependency on LIBOR.

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Liang Wu is a Vice President of Financial Engineering and heads up CrossAsset Product Management at Numerix. Mr. Wu previously served as Director of Financial Engineering in the Client Solutions 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 the University of Science and Technology of China.

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