



LIBOR alternative rates: The transition and the future of OTC derivatives pricing and curve construction

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The development of new reference rates alternative to LIBOR are expected to have direct consequences for derivatives contracts, particularly for those that do not mature until after 2021. Important steps are already being taken to address this change, but some questions still remain, such as what happens to LIBOR-based products should LIBOR no longer be available? And how will LIBOR alternative rates impact derivatives valuations and curve construction practices going forward? We discuss these issues and the preparations derivatives market participants should consider to ensure a smooth transition.

In the early days following the financial crisis, the shift to overnight indexed swap (OIS) discounting may have sounded like quite a leap from the familiar single curve approach. As consensus formed around the significant disparities in pricing through the LIBOR approach, leveraging multiple pricing curves for discounting and forecasting has earned its place as the market standard for garnering improved profitability and limiting risk. However, as banks switched over from LIBOR curves to OIS curves for discounting their derivatives portfolios, this shift did not come without challenges, and derivatives pricing approaches have remained complex.

Today, LIBOR-based instruments are still heavily relied on for forecast curve construction. But given the option to no longer support LIBOR after 2021, and with the search for several new alternative short-term interest rates underway, banks are starting to evaluate what the impact will be on derivatives pricing and valuations going forward. Currently, when multi-curve pricing is applicable in a market, the process remains the same: one curve (OIS) is used for discounting and multiple LIBOR forecasting curves are used for different LIBOR tenors (3-month, 6-month, etc.). When multi-curve pricing is not applicable in a particular market, a main IBOR can be used as either a forecast curve or a discount curve.

THE TRANSITION

With LIBOR having undergone serious reforms in the past years, it might never officially go away, but the FCA, the UK's financial services industry regulator, announced that it will no longer compel banks to use LIBOR after the end of 2021 as the benchmark for short-term interest rates in the interbank market. After this time, it will be up to the panel banks to decide LIBOR's future.

Given this element of uncertainty, market participants should not rely on the availability of LIBOR after 2021, and thus should also recognize the risk that LIBOR forecast curves may no longer be produced. Recognition of the long-term unsustainability of the current LIBOR is leading many central banks to seek for one or more successor alternative rates (there is not yet any consensus on a global replacement rate). It appears that the likelihood will be different reference rates for different markets, and industry groups have already started planning for an orderly global transition to alternative rates.

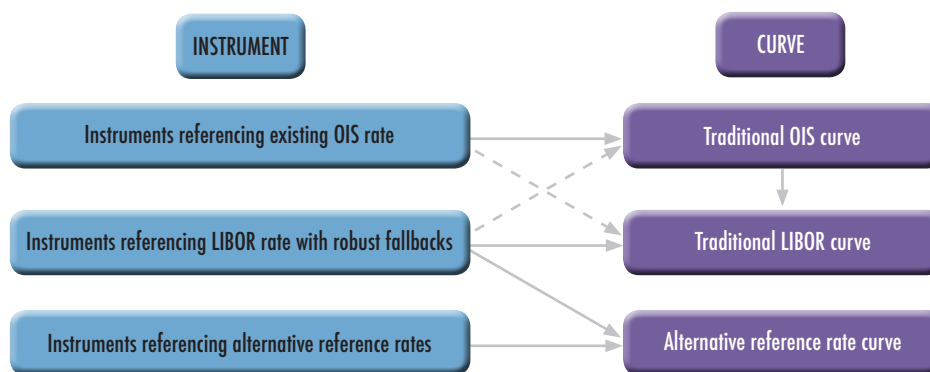
If we look at the transition between now and 2021, we will see many alternative reference rates come into the picture. It is important to note here that there is also some uncertainty around the continued use of existing OIS discounting curves. For certain currencies, if there is a widespread decision to retire their individually applied overnight rates, there will be a total shift to a new alternative rate for each currency. This could have serious impacts on derivatives valuations overall.

LIBOR may never officially go away, but market participants should not rely on its availability post-2021.

Regarding new derivatives contracts issued between now and 2021, it is likely they will continue to be based on LIBOR, but should be flexible so they can be adapted to a replacement rate if LIBOR is no longer available. However, it is possible some current contracts do not include any such language. Holders of these contracts should try to either get fallback language written into the existing contract that accounts for a permanent discontinuation of LIBOR, or make preparations to switch contracts if LIBOR ceases publication.

IMPLICATIONS FOR CURVE CONSTRUCTION

As the market evolves, new curve construction approaches could emerge as instruments begin referencing alternative rates. So, let's look at some details concerning instruments and curve mapping.



As the market evolves, new curve construction approaches could emerge as instruments begin referencing alternative LIBOR rates.

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. Or if you want to directly use the OIS instruments or OIS basis instruments together with the LIBOR instruments, you can use "global solving" to construct your LIBOR curve and OIS curve.

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 valued 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.

PREPARING FOR MARKET CHANGE

The establishment of new reference rates will kick off the market's potential transition away from LIBOR. Different currencies will have different rates. For example, in the U.S. the Federal Reserve Bank of New York and the U.S. Treasury Department introduced SOFR (Secured Overnight Financing Rate) earlier this year as a replacement to U.S. LIBOR; while for the Swiss franc, SARON (the Swiss Average Rate Overnight) was already in place as the alternative to CHF LIBOR since October of 2017.

The new reference rates for all currencies will be included in contracts' fallback provisions to help allow for a smooth transition between the legacy contracts and any settlements. If a market participant wants to switch a legacy contract, it will be linked to the new reference rate. Of course, new contracts will reference the new reference rates. If we see liquidity picking up for these new contracts, there should be more accommodation from the market to use the new rates, and might encourage more people to switch from legacy contracts to new contracts.

It is important to note here that ISDA (the International Swaps and Derivatives Association) is taking charge of an effort to determine sufficient robust fallback rates and mechanisms, and is also working on a plan to amend legacy contracts.

Much work will need to be done to effect a successful transition. The way forward is not yet entirely clear. I expect that regulators and industry groups will work hard at developing solutions so as to avoid the triggering of any market disruption.

Much work will need to be done to effect a successful transition away from LIBOR should participating banks choose not to support it in the long term.

KEY TAKEAWAYS

- With the long-term sustainability of LIBOR potentially in jeopardy, this signals a major change in derivatives valuations and curve construction practices.
- While there is the possibility that LIBOR is here to stay (and if so, it will probably sit alongside alternative rates), it is generally advisable for market participants to also consider alternative rates.
- 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.
- For existing agreements maturing after 2021, market participants should examine the documentation to identify any fallback provisions that are included in the event that LIBOR is unavailable.
- A "wait and see" attitude is unwise. If a LIBOR substitute is not expressly incorporated in a contract, there should be an attempt to get the contract amended. Post 2021 legacy instruments lacking fallbacks may be subject to considerable uncertainty.

ABOUT THE AUTHOR



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