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Benchmark Reform: How to Get Started with your IBOR Transition Planning

Julia: Hello and welcome to this DerivSource podcast. I'm Julia Schieffer, the founder and editor of DerivSource.com

For many financial institutions, benchmark reform is clearly an agenda item for 2019; however, given the sheer scale of work required to transition away from interbank offered rates or IBORs to alternative reference rates or ARRs, firms need to be hitting the ground running.

Over the summer of 2018, a group of trade associations including ISDA, AFME and SIFMA, published a Global Benchmark Report which surveyed 150 organisations and found largely that although the awareness of benchmark transition issues is at a high level, the level of preparedness among those surveyed was at an early stage.

In the podcast we aim to give you some practical steps and timelines that you should be working towards to get their benchmarking reform programmes underway. After all, 2021 is not that far way and with the magnitude of the change being compared by some to Brexit and Y2K, firms will need all the time they can get to complete the transition successfully.

With me to offer you some expert insight into this topic is Shankar Mukherjee, UK Financial Services Partner and IBOR Lead at EY.

Welcome to the podcast Shankar.

Shankar: Thank you very much – very glad to be here.

Julia: So let's start with why now. Why is it important that financial institutions start preparing for IBOR now?

Shankar: So, I think it's incredibly important that financial institutions really engage with the process of transitioning from IBOR, and while there is regulatory pressure to do this, I think the bigger driver for this is really the scale of the challenge.

IBORs and LIBOR, in particular, have been in use for the last 40 years, and it's not widely appreciated how deep the systemic footprint of LIBORs across the financial system is now. To the extent that, if you asked most firms to tell you what their exposure to LIBOR was across the different rates, across different currencies, across different tenors, how much of that exposure is expected to mature before 2021, which is the timeline that Andrew Bailey drew out in his speech - most large global firms would struggle to do that. So, the scale of the challenge makes it really important that firms start to take steps now.

The other thing that is driving the urgency is that it's not well-understood what the financial implications of the move are going to be. In many ways, this is a change in the underlying structure of the market, where you're moving away from LIBOR, whether it's used in derivative transactions, whether it's used in cash products for loans, to different reference rates. And those reference rates are very different from LIBOR as it stands today. So, it's fundamentally going to alter the nature of these transactions, and that's why taking action now is really important.

Julia: what is the first step firms should be taking as they prepare for IBOR?

Shankar: So, I think, as I mentioned, there are a few things that firms should be thinking about doing now. One of the first things would be doing what we call an "impact assessment," and that impact assessment involves, at a minimum, looking at the impact across four dimensions. So, the first dimension is, "Do you understand what the exposure looks like across your different products, across different currencies, and across the contractual maturity of different transactions?" So, in other words, are you able to say, "How much of my derivatives population reference say 3 months dollar LIBOR, what the maturity of that trade looks like." So, that's the first part of the impact assessment.

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The second part of the impact assessment is looking at "What are the contracts that sit behind those products?" And that's really important because a critical part of the market transition is really improving fallback language.

And fallback language, we can think about as the seatbelt in this environment. So, let's consider a scenario where LIBOR actually is permanently discontinued post ... the end of 2021. In that scenario, if you look at your existing contracts that reference LIBOR, how will you settle the payments on those trades because LIBOR is no longer published. So, the fallback language in contracts tells you what you should be referring to in that stress scenario. So, that's why we refer to it as the "seatbelt." So, that's the second part of your impact assessment.

The third part of your impact assessment needs to look at "What are all of the impacted processes and systems across the entire firm?" So, here, we are talking about major processes, like funds transfer pricing, we like to point out, is one of those processes which is likely to be heavily impacted by this change because most firms don't have FTP systems that can deal with a multi-rate environment. So, we think that that's a major impact. You also need to look at, "What are all of the impacted systems?" And typically, making any kind of change in your technology stack is a really complex processes for banks, and they already have full book of work for changes to their technology for various regulatory and business-driven reasons. So, understanding the impact on the systems environment is really important. In this instance, we are looking at an effort that is analogous to, say, the Y2K process, where you literally had to through the code for every single system and find out whether LIBOR was hard-coded into the system.

And because this rate has been around for so long, the better part of 40 years, it's used widely within firms as a proxy for short-term interest rates. So … which brings me to the fourth leg of our impact assessment, which is around risk and valuation models. So, let's say that you don't have a mortgage that references a LIBOR, but the prepayment model that you have for your mortgage book is very likely built using LIBOR. The calibration of your VaR engine, which is used to calculate market risk capital is very likely built using LIBOR. So, the footprint of LIBOR across the risk finance capital models is extremely significant and not well recognised.

So, the other part of the impact assessment would really look at, "Do you understand what the model inventory landscape is, and which are the heavily impacted models and what is a process to change them?" So, one of the first things to do, really, is do this impact assessment. The other things that firms should be doing, clearly, is putting in-place a transition plan, right? You need to have a roadmap to say, "How are you going to manage this transition away from LIBOR?" And along with that transition plan, clearly, a project plan and a governance structure to deliver that. How are you going to implement this on time?

Another critical part of what firms should be thinking and doing now is a client engagement and outreach strategy. So, let's not forget that, while banks are heavily impacted and will have to process all of these changes for their contracts and their systems, there is a counterparty on the other side that's impacted. In some cases, those counterparties are relatively sophisticated counterparties, particularly the derivatives market, but when you look at cash products, bonds, loans to SME clients, these exposures are very widely distributed through the system. And banks need to get on the front foot, engaging with their clients and explaining to them why is a change happening, how banks are proposing to go about the change, and what the likely impact on their clients is going to be.

And this is a critical part of what banks need to be thinking and doing now.

Julia: So you've mentioned the impact assessments and the various steps, what about the realistic timelines firms should be working towards?

Shankar: So, let's look at the timelines, right? What are the markers? So, the most important one, probably, is Andrew Bailey's statement, which says that after the end of 2021, the FCA will no longer compel banks to contribute to LIBOR. So, we have to entertain a scenario where, after the end of 2021, LIBOR is no longer published. So, you need a transition plan which basically allows you to migrate all or substantially all of your new transactions onto the new reference rates and away from LIBOR. You also need to understand, plan, and agree what you are going to do with your legacy portfolio. So, like we said, you don't want to be in a situation at the end of 2021 where LIBOR is discontinued and you've got a big legacy portfolio that is referencing LIBOR and you're unable to settle the payments.

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So, in other words, you need to have a strategy and a transition plan, both for new products and your legacy products, and that needs to be executed before the end of 2021. Even before that, there are potentially other deadlines. So, for example, the current timeline for compliance with the EU benchmark regulation is the first of Jan. 2020, so that's two years before the LIBOR deadline. Now, we know that the Euro RFR Working Group has petitioned the European Commission to extend that timeline by two years. We are still awaiting the formal response from the European Commission, and it's going to need an act of European Parliament to make this happen. So, don't underestimate the challenge of that actually coming to pass.

So, again, firms need to have a backup plan. What if you don't get an extension of the EU BMR timeline? So, those are some of the timelines, and given the scale of the challenge, most banks recognise that three years between now and the end of 2021 is not a lot of time to execute something of this scale. And it's comparable to the largest project that firms have undertaken.

Julia: Going into a little more detail into the steps to be taken, can you give us an idea of what an IBOR transition plan should or will look like?

Shankar: Yeah. So, I think the transition plan needs to consider a few elements. So, one would be, "What are you planning to do with your new products?" Because one of the challenges that we have at this time is that the stock of LIBOR products is actually increasing every day. It's not declining. So, to give you an example, the volume of Eurodollar futures, which references 3-month dollar LIBOR, hit a record on CME in the month of April. So, in other words, the stock of contracts continues to increase, and this is important for two reasons. Firstly, the scale of challenge, therefore, for the banks to implement that change is growing. It's not diminishing, and the second thing is, at the FCA, in their statement, in Andrew Bailey's statement in July the 19, said that banks need to be very aware that when they are transacting in products that reference LIBOR knowing that that index may not exist in three years' time, how are banks ensuring that their clients are not adversely impacted by that change?

So, there is a conduct/legal/reputational risk associated with continuing to transact in LIBOR products. So a big part of the transition plan really needs to be how, for different types of products, you plan to transition away from LIBOR-denominated products to alternative reference rates. And we have done some thinking around what the sequence of that would look like. Very broadly, we think that's the derivatives market going first, the wholesale funding market following, wholesale lending after that, and retail products. And that probably is both in increasing order of complexity of execution as well as decreasing order of sophistication of the clients you're dealing with. So, we think that that's sort of the sequencing in the market. So, that's one part of the change where you need to think about "What are you going to do about transition to the new products?"

A key part of that challenge is going to be, "How do you set up the operating infrastructure to make sure that you're able to price risk-managed trade products in denominated in the new alternative reference rates," right? So, whether that's cash products or derivative products. So, setting up and testing that operating infrastructure is a key part of the transition as well.

You also need to, then, think about and have a strategy about how you're going to manage legacy contracts, right? So, if you look at your portfolio, you'll have a portion of the portfolio which will mature before 2021. So, that's sort of a natural roll-off, and you'll assume that that's fine. You have a strategy for how you migrate new contracts to the new rates, and then you need to think about, "What do you do about the legacy portfolio?" Do you have a strategy to make sure that the fallback language in the portfolio is strong enough so it will survive a post-LIBOR world? Or, do you need to go back and repaper those contracts, which is a tremendous challenge for most firms? So, if you take an example of the bond market there, for example, in most instances, because bonds are held through nominee accounts, through Euroclear, Citadel, Clearstream et cetera, you don't know who the end investors are.

And changing economic terms of bonds is a very complex process, typically requiring a quorum of investors, two-thirds, three-quarters, sometimes a unanimous investor vote. So, that process is both legally and operationally very complex. You actually have to call a meeting of bond-holders, a physical meeting of bond-holders as well. So, thinking, "How do you address the problem with your legacy portfolio?" Is really important as well and one of the things that banks need to think about straightaway.

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Julia: And as firms work towards these transition plans and programmes, what are some of the challenges that they may face?

Shankar: So, we've talked about some the legal and contracting challenges already, and I think that's very significant. We've talked about the challenges that ... in terms of changes to models, which are very deep within the banks. There's another bit that I think is really important. This is one of those transitions that impacts every product, every business area, within the firm, and secondly, it impacts every enterprise function as well: risk, finance, treasury, legal, ops, technology. So, standing up a programme which cuts across all of the business lines for the banks - global markets, global banking, retail banking, insurance, asset servicing, as well as all of the enterprise-functional areas, like risk, finance, et cetera, is a very complex job.

And if you think about, now, that a bank that has got a global footprint, also has to deal with the additional challenge that different currencies are going to transition at different times and also different products are going to transition at different times ... So, the challenge that you have, say, for a Spanish mortgage or a US retail mortgage is going to be very different from changing the terms of a swap with a large corporate. So, in addition to the cross-business and the cross-enterprise function challenge, this is not like, say, the introduction of the euro, where you had a fixed date, you had agreed terms at which every currency would switch over into the euro, and you had a legal framework under which every contract would be changed. So, the analogy here is more to Brexit, where there is a lot of uncertainty about what that end state looks like, but nevertheless, banks need to take action in order to prepare for whatever that end state might be.

So, you need to outline very clearly up-front what your assumptions are. You need to have a very robust process of testing those assumptions as you move through the process. Again, some defined milestones are trigger events. So, one of those trigger events, for example, would be when ICE Benchmark administration concludes its consultation around which banks might continue to contribute to LIBOR post-2021. That's an important decision point. If the conclusion of that consultation is that most of the panel banks will not contribute, you might need to accelerate your contingency planning. So, not only is it complex in terms of the spread of business and products and enterprise function, but it's also subject to a lot of moving parts in the environment, and you need an assumption-driven plan that you test regularly at a central level.

So, I think organising and executing this complex program in and of itself is a big challenge for firms.

Julia: What about the level of uncertainty surrounding benchmark reform? Does this uncertainty pose as a challenge for firms?

Shankar: So, it's fair to say that some firms were thinking about whether this transition is really going to happen, just given the level of uncertainty associated with the change as well as the size and scale of impact. In that context, the "Dear CEO" letter jointly issued by the PRA and the FCA has been extremely helpful. I've actually had a number of banks saying that they welcome the letter because it has allowed them to ensure that it gets senior management attention and the appropriate level of sponsorship. So quite importantly, the "Dear CEO" letter specifically asks for a senior individual to be named as responsible for this transition plan and for the transition plan to be approved by the board. So, both of those things really served to raise the importance of these issues within the banks and make sure that, A, it's a part of their overall planning and, B, very importantly, allow firms to start budgeting for some of the costs of execution. And that is really critical as firms grow through their budgeting and planning exercise around this time of the year.

Julia: And final question here, what are some of the benefits firms can achieve if they prepare early?

Shankar: So, I think that's a great question, and there is a temptation here to see this a regulatory-driven change. And that view is not entirely correct, in our view, because, like I said at the outset, this is a fairly fundamental change in the market structure. It's going to change how derivatives, how cash products, loans, retail products are priced, risk-managed, and valued. So there are important pricing strategy questions to be addressed up front, in the absence of which there is potential for firms to lose market share in the new products that are going to be introduced, in their ability to service their clients' requirements, and, indeed, for some of the early movers to take advantage of some of the market dislocation, to both protect their market share and indeed grow it.

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You also need to think about the fact that there will be some impact banks' balance sheets. For example, LIBOR currently is a contra-cyclical index, which means that, in times of stress, LIBOR tends to go up and banks' net interest income tends to go up. When LIBOR is replaced by the new alternative reference rates, they behave very differently in times of stress, so this has important financial impacts on the bank. So, you need to think about the change, both in terms of the operational cost of implementing the change, but also, what does that mean from a P&L perspective for the banking book, for the trading book, and for the treasury? And I think the other part of doing it right and getting started early is also being able to address conduct issues early on. Identifying conduct and client issues, potential client issues, early on, having a strategy to address them, being able to demonstrate to the regulators that you have thought about how you will mitigate potential adverse client impacts is, I think, a critical part of getting this right.

Julia: Great. That's excellent insight and some very good practical knowledge for our audience as they prepare their benchmarking reform programmes. Thank you for joining us today Shankar.

Shankar: Thank you. It's been a pleasure.

Julia: To find out more on this topic, including links to references that you may find useful, please go to our show notes page. On DerivSource.com Also, Shankar Mukherjee will be presenting on this topic at the DerivSource Community Forum event in London on Nov 14th so if you are in London please do register and you can find all that information on DerivSource.com Otherwise, thank you so much for listening today. Join us next time.

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