



Capital Markets Risk Intelligence #3

FCA's announcement on the end of LIBOR and its effect on Financial Institutions

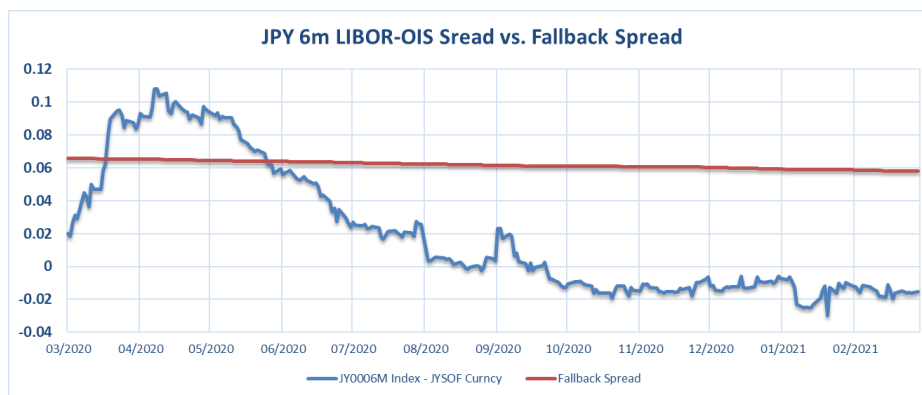
BACKGROUND

- On 5th March 2021, the FCA announced the end of the LIBOR benchmark and the loss of indexality.
 1. The FCA confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative, immediately after 31st December 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings.
 2. In addition to above, LIBOR settings will either cease to be provided by any administrator or no longer be representative, immediately after 30th June 2023, in the case of the remaining US dollar settings.
 3. Immediately after 31st December 2021, 1-month, 3-month and 6-month JPY LIBOR, 1-month, 3-month and 6-month GBP LIBOR will not be offered or there's a possibility that Synthetic LIBOR will be used with FCA's public consultation as a condition. (However there's no indexicality and scope of application is limited.)
 4. Immediately after 30th March 2023, 1-month, 3-month and 6-month USD LIBOR will not be offered or there's a possibility that Synthetic LIBOR will be used with FCA public consultation as a condition. (However there's no indexicality and scope of application is limited.)
- Bloomberg Index Services Limited (BISL) has judged that FCA's announcements apply to Index Cessation Event of ISDA protocol, and then confirmed the adjustment spread of all LIBOR (i.e. all currency and tenor) on 5th March 2021, based on "IBOR Fallback Rate Adjustment Rule Book"
- Through a press release, the IBA announced consultation results regarding the end of LIBOR's benchmark at 4th December 2020, and showed that many market participants agreed to this consultation.
- ISDA has announced guidance to reduce market risks for related parties, of over-the-counter trades, effected by the FCA's announcement, as well as consistent application to order trigger and fallback by market participants.
- US ARRC has supported the FCA's announcement and repeated their advisory to end new trades of US LIBOR.
- The FSA and Bank of Japan considers Synthetic LIBOR to be used as a safety net, based on the assumption that each FIs are required to correspond to the transfer plan announced by the review committee on JPY interest-rate index. Therefore new contracts and trades referring those should be phased out completely.

KEY CONSIDERATIONS

- Receiving the FCA's statement, Cessation effective date after fallback spread has been confirmed. From this, the estimation of cashflow referring to LIBOR, which will be fixed after Cessation effective date will be categorized into the following 2 methods; a method which uses forward LIBOR and another method which uses forward OIS with adjustment spread. Currently, the former method has been used more in FIs, however, at some point in the future, this method needs to switch to the latter. One thing to note is that there may be some cases where the market price jumps discontinuously when there's a difference in the market price. FIs need to carefully monitor the situation to determine the timing to transition from one method to the other.

Below chart compares the past movement of JPY 6m LIBOR-OIS spread (Blue) and Fixed Fallback spread (Red). In the most recent point, there's approximately 7bps of divergence between the fallback spread.



- The Alternative Reference Rate Committee (ARRC) are repeating their advisory to end trades which refers USD LIBOR within this year. USD LIBOR is an important benchmark for Japanese FIs and firms. Since the end of USD LIBOR has been suspended for 18 months, leading some grace period for fallback correspondence referring USD LIBOR. On this occasion, each FIs and firms would like to complete organizing structure by proceeding structure for new trade of derivatives and financial products referring SOFR. We'd anticipate market makers to increase liquidity of derivatives referring SOFR. On the other hand, FIs and investors, who are on the buy side, needs to rush organizing the treatment system of financial products referring SOFR. This includes correspondence for systems with a high dependence on 3rd party vendor systems as well as risk management and clerical operations.
- Some FIs have expectations towards Synthetic LIBOR. The FCA will start consultation on Synthetic LIBOR by considering legacy positions. However, Synthetic LIBOR doesn't have any indicator and it only applies by keeping legacy positions in mind. The definition of a legacy position itself will be decided by consultation and it's unclear which parts will be covered in the current trade at this moment. Therefore Japanese FIs shouldn't have excessive expectations towards Synthetic LIBOR and correspond to LIBOR transition.
- There are many FIs which focuses on securities denominated in foreign currencies as a banking account. There are many securities with variable interest rates, and we need to keep the implication towards CLO investment in mind. Fallback language which ARRC recommends includes early opt-in regards fallback for relative loans and syndicated loans as well as Asset replacement trigger for CLO. Therefore, if early opt-in CLO, supporting assets, proceeds without waiting and ratio of loan above certain level is fallbacked to SOFR+ adjustment spread, there's a possibility where pre-cessation trigger is pulled. Each FI needs to consider and prepare for all risks which could happen when corresponding to early fallback.

APPENDIX

- [Announcements on end of the LIBOR \(FCA\)](#)
- [ARRC Commends Decisions Outlining the Definitive Endgame for LIBOR \(ARRC\)\]](#)

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The discussions and actions from various points of view throughout the LIBOR Transition process are an opportunity to strengthen risk management capabilities to uphold businesses rather than ad-hoc events. Throughout the transition process, Deloitte Tohmatsu comprehensively advises from accounting, tax, legal, financial risk management points of views.

[Logic and numerical survey regarding yield curves which accompanies LIBOR transfer \(Japanese page\)](#)

Prior Articles related to LIBOR is here [<link>](#)

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