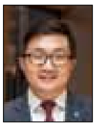
LIBOR disappearance by 2021: What does it mean and how to respond to it?

The UK Financial Conduct Authority announced on the 27th July 2017 its intention to dismiss banks contributing to the London Interbank Offered Rate (LIBOR) calculation from their obligation to participate in the LIBOR fixing from 2021 onwards, which means that LIBOR and other interbank offered rates (IBORs) may cease to exist beyond 2021. JUSTIN ONG and LEONG GHAI JON write.

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This has put both Islamic and conventional financial institutions with significant exposure to LIBOR in a difficult situation. They have to transition away from LIBOR as the go-to reference rate. This is due to the extent in which LIBOR is used in the financial world, having been the reference rate that underpins more than US$200 trillion of financial contracts, derivatives, bonds, loans and other exposures worldwide.

Various national working groups have been established for each of the five LIBOR currencies to facilitate the transition process. Each working group has selected their preferred alternative reference rate for LIBOR, but the transition progress for each currency is at different stages, with some currencies more advanced than others.

With Islamic finance deeply rooted in such an interconnected global banking system, Islamic financial institutions cannot simply invent their own reference rate. They may also

Table 1: Most affected areas of LIBOR discontinuation

Area	**Business volumes and profitability**	**Accounting**	**Valuations and risk management**	**Governance and controls**	**Legal**
Description	Potential of increased exposure to market volatility on capital markets underwriting businesses in debt capital markets and equity capital markets, repo/prime brokerage offerings and rates trading.	The transition may result in complications related to fair value designation, hedge accounting and inter-affiliate accounting structures.	The transition of legacy contracts could potentially result in less effective hedges and/or market valuation issues and may require adjustments to address inherent differences between the IBORs and alternative reference rates.	Institutions must have robust governance and controls to manage the transition of contracts to alternative reference rates.	Contract amendments will lead to increased transition costs and operational risk. A significant administrative effort associated with transitioning contracts to the alternative reference rates will be required.
Potential impact	Reduced commercial profitability due to either over- or underpricing when pitching for: investments, deployment of balance sheet (lending) or distribution of securities.	The transition from IBORs to alternative reference rates may create a valuation change for IBOR-linked legacy contracts that may impact the financial statements. If the IBOR is not effectively offset by the alternative reference rates, then financial instruments and their respective hedges may need to be booked separately. Having hedges booked separately and recorded at fair value may result in net income volatility and growing balance sheets.	Any instrument with a contractual instrument that references LIBOR (interest rate swaps; cross-currency swaps, etc). Any instrument discounted with a curve bootstrapped from a LIBOR-linked swap. Greater volatility in the valuation of derivatives and fixed income instruments arising from uncertainty.	The definitions of the governance and oversight functions will facilitate an in-time definition of the LIBOR transition approach; this will guarantee commercial advantage and drastically reduce the risk of disputes/fines.	The conversion of legacy contracts to alternative reference rates may require consequent amendments to other contractual terms, resulting in significant upfront transition costs and increased operational risk. If transitioning to the alternative reference rate would result in a breach of contractual terms or the obligation to take certain actions, parties may not agree to move to the alternative reference rate.
Actions	Semi-annual — impact assessment • Perform an in-depth analysis of your exposure to LIBOR. • Raise awareness internally to ensure commitment across the firm. • Define your action plan according to the exposure assessment of cross-currencies and instruments.			Set up a LIBOR working group and define the governance and oversight functions.	Involve your legal function in the LIBOR transition working group and monitor market best practices such as the International Swaps and Derivatives Association (ISDA)'s consultation on fallback clauses.

Source: Authors' own

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have to rely on bigger and more liquid LIBOR replacement reference rates as a benchmark to determine the profit rate.

Why is LIBOR being discontinued?

The main cause of LIBOR transition is due to the significant decline in the transaction volume of LIBOR-denominated exposures, which leads to increasing reliance on judgments of panel banks to determine the interest rate, rather than actual transactions.

In addition, the disclosure of collusive actions by several banks contributing to LIBOR in 2012 to manipulate the interest rate has caused the financial sector to further question the reliability and credibility of LIBOR to reflect the true borrowing cost in the market.

What does LIBOR discontinuation mean?

The LIBOR migration will have material effects on commercial, procedural and technical aspects for all organizations, including Islamic financial institutions with significant exposure to LIBOR. Given how deeply LIBOR is embedded in today's financial market, the following shown in Table 1 will probably be the most affected areas.

Particularly in valuation and risk management, the following areas will be affected by the transition away from LIBOR:

1) Pricing and valuation of derivatives
The retirement of LIBOR will directly affect the pricing and valuation of existing financial instruments and derivatives. The impact of the discontinuance of LIBOR will also affect the Islamic finance industry, where LIBOR is widely used as a benchmark to determine the profit rates for Islamic financing arrangements and Islamic derivatives. For example, one of the most common Islamic derivatives used by Islamic banks nowadays are Islamic profit rate swaps, some of which use LIBOR as a benchmark. As a result, the discontinuance of LIBOR may potentially lead to significant changes in the value of those products.

Islamic financial institutions with open contracts extending past the transition date of 2021 may see their contracts decline in value, while others may experience the opposite during the transition period. It will be important to identify a relevant alternative benchmark rate to replace LIBOR and determine the impact of such a transition and the fallback mechanism for legacy contracts.

For new contracts however, it is a matter of selecting the basis to use for derivatives with regards to the valuations and settlement. It is also important to note that if LIBOR is still preferred for contracts for the time being, Islamic financial institutions must ensure that a fallback mechanism to an alternative benchmark rate is included in the contracts to minimize any value transfer at the point at which the LIBOR is no longer available.

2) Interest/profit rate term structure
LIBOR is forward-looking for various terms up to 12 months but most alternative reference rates are historically overnight risk-free rates (RFRs) and are not sufficiently liquid at the time being to construct a forward-looking term structure. Unlike LIBOR which provides upfront certainty of the yield curve used to price any derivatives, the lack of a term structure for alternative reference rates such as Sterling Overnight Index Average (SONIA) and Secured Overnight Financing Rate (SOFR) at the moment creates uncertainty in the future interest rates and complicates the basis used to price derivatives and introduce basis risk which could lead to ineffective hedging relationships.

There are two options to address the lack of a term structure. The first option is using alternative reference rates compounded in arrears calculated by compounding the historical interest rate over the relevant interest rate period. The second option is to derive the term rates implied from a derivative market, similar to the derivation of LIBOR rates.

Option 1 is currently favored within the industry as it reflects actual daily interest rate movements during the relevant period and is less volatile. The main disadvantage of Option 1, however, is that the interest rate cannot be determined at the start of the relevant period and this may create uncertainties for investors.

Option 1 and Option 2 may co-exist in the future to suit different needs of market participants although the alternative reference rates such as SONIA and SOFR are not sufficiently liquid to create a reliable and consistent term structure at the current stage.

The unavailability of Option 2, for example in a forward-looking term structure, would be problematic for many Islamic financing products and transactions given that, in order for these products to comply with Shariah law principles, the pricing of an Islamic transaction must be determined at the start of the relevant period. Hence, it is important for Islamic financial institutions to monitor market developments when it comes to choosing a replacement benchmark for LIBOR as to whether it is consistent with Shariah law principles.

3) Spread adjustment
Alternative interest rates such as SONIA and SOFR are based on historical overnight rates rather than quotes provided by panel banks and are considered risk-free. One of the main differences with LIBOR is that alternative interest rates are risk-free rates and do not take into consideration the counterparty credit spread. For example, there is significant variance between three-month LIBOR and three-month average SOFR and SONIA, which is due to the inclusion of credit spread in the LIBOR rate.

Hence, in order to fully transition away from LIBOR, Islamic financial institutions not only have to choose a suitable benchmark rate to replace LIBOR, but they must also take into consideration the new methodology that is established in the market to estimate the credit spread. Based on a survey by the ISDA, spread adjustment based on a historical mean is the favored methodology, but it may not be suitable for every organization because of its limitations in that it requires data for long lookback periods and could lead to value transfers.

4) System and infrastructure
Significant changes arising from LIBOR transition in terms of treasury

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and trading systems, pricing curves, data sources and internal valuation models may introduce significant operational risk to an organization. Significant effort is required from an organization to update the associated technology and system infrastructure to integrate the newly adopted alternative interest rates. Given the different methodologies to calculate the risk-free rates and spread adjustments, it may prove challenging for organizations to complete the transition process in time.

How do you respond to the transition?

While the end of 2021 may seem far away, the magnitude of the transition away from LIBOR and its potential impact on the financial markets cannot be underestimated. It is important for both conventional and Islamic financial institutions that have significant exposure to LIBOR to start taking the necessary steps to address and facilitate the transition by:

- Identifying current exposure to LIBOR and actively reduce reliance on LIBOR by developing a clear understanding of the products and transactions that are affected by LIBOR transition, whether their maturity extends beyond 2021 and any interdependencies with other products.
- Developing transition plans for existing and new products by determining the fallback mechanism and assessing the level of consent that would be required to replace LIBOR.
- Assessing the readiness of the existing system and infrastructure to cater for the changes in reference rates by understanding the operational changes and efforts required to implement the required changes.
- Setting up internal working groups and a governance structure for the transition by increasing awareness internally and communicating transition plans with external parties.