On the LIBOR Transition

Q #1 When will LIBOR phase out and which rates will be replacing it?

The London Interbank Offered Rate, also known as LIBOR®, is a widely-used index for short-term interest rates that is commonly found in loans, derivatives and bond documentation. It is administrated by the ICE Benchmark Administration (IBA). Currently, LIBOR is calculated for five currencies (USD, GBP, EUR, CHF and JPY) and several tenors in respect to each currency.

During the 2008 financial crisis, several LIBOR panel banks were accused of manipulating the rate, which led the UK Financial Conduct Authority (FCA) to decide that panel banks will seize to submit the rates required to calculate LIBOR as of the first of January 2022.

More specifically, the FCA has recently confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative:

- immediately after 31 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; and
- immediately after 30 June 2023, in the case of the remaining US dollar settings.

The announced cessation of LIBOR leaves market participants wondering which are the most appropriate replacement rates. The risk-free rates, or "RFR", which are overnight interest rate benchmarks, have been considered by several jurisdictions to be more representative and reliable than LIBOR.

As such, specific RFRs have been identified for the relevant currencies linked to LIBOR, namely, the Euro short-term rate (€STR) for EUR currency, the sterling overnight index average (SONIA) for GBP, the secured overnight funding rate (SOFR) for USD, the Swiss average rate overnight (SARON) for CHF and, finally the Tokyo overnight average rate (TONAR) for JPY.
Q #2 Why does LIBOR matter to investment managers?

Investment managers are significant users of LIBOR, be it for investment, benchmarking or valuation purposes. Investment managers are exposed to LIBOR mainly through products such as money-market funds, by holding financial instruments such as LIBOR-based Floating Rate Notes, securitizations, or private debt. Managers may also be exposed to LIBOR via interest rate derivatives, often entered into for hedging purposes. Another use is cash collateral indexed to LIBOR remuneration.

They further use LIBOR to compare their investment vehicle performances, aim for a certain performance target or calculate performance fees. Sometimes they use LIBOR as a reference indicator.

Finally, LIBOR is widely used in accounting systems and pricing models, and more generally in operations or administration systems. These tasks are often delegated to third parties which require good coordination to implement changes.

Considering the wide usage of LIBOR in key areas of investment managers’ operations and the imminent cessation of the rate, market participants should refrain from issuing new products linked to LIBOR and transition away from it in legacy contracts.

Q #3 What are the main challenges when it comes to the LIBOR transition?

Transitioning away from LIBOR represents a major challenge for investment managers, who should make the necessary arrangements to ensure a smooth and prompt transition despite remaining uncertainties.

As a first step, a smooth transition requires an appropriate and dedicated internal organisation: market participants need to assess the impact of transitioning away from LIBOR by identifying all the financial instruments, businesses, models and contractual documentation, among others, that are directly affected by the upcoming cessation of LIBOR.

Two main steps usually follow such an assessment: transitioning to the extent possible and/or organising fallbacks.

Investment managers should switch as early as possible to new LIBOR successor rates based on RFR. For legacy trades that mature after 2021 - or mid-2023 for some USD LIBOR tenors - and that cannot be renegotiated or unwound before those dates, robust fallback language should be introduced in the existing contracts to manage the cessation of LIBOR, using for instance the ISDA Protocol for derivatives transactions. Even for new transactions or contracts based on RFR, fallback language should be introduced to manage any cessation risk in the future.
Choosing the most appropriate successor rate is not always straightforward. Indeed, LIBORs are forward-looking term rates whereas RFRs are overnight rates with no term element (no maturities).

Depending on the economic sector, the type of assets (cash vs derivatives) or any other specificity, successor rates may be either straight RFRs, RFRs adjusted by a spread to aim for the closest economic continuity or even new term-rates based upon RFRs.

Various groups of private administrators, national and supranational competent authorities are working on these different alternatives. Liquidity, especially in the derivatives market, will be a key element in the determination of possible term-rate successors.

Despite the above-mentioned uncertainties, I encourage investment managers to use the many tools already available for both transition and fallback, while keeping a close eye on any new development in this matter.

June 2021

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