Beat Deadline Drama by Tackling the LIBOR Transition Today

By **Ben Poole**, Columnist

The end date for LIBOR is just months away. For those treasurers who haven't acted already, now is the time to identify LIBOR exposures, have a contingency plan for accidental oversights, and understand the different challenges presented by the new market risk-free rates.

Following years of planning and speculation, 5 March 2021 saw the cessation dates for the publishing of the London Inter-bank Offered Rate (LIBOR) confirmed by both the UK Financial Conduct Authority (FCA) and LIBOR's administrator, ICE Benchmark Administration (IBA). This brought some much-needed clarity to the LIBOR transition timetable for banks and corporate treasurers. The outcome of these statements is that 30 LIBOR settings – all non-US dollar tenors plus one-week and two-month US dollar LIBOR – will either cease or become non-representative after 31 December 2021, while the remaining five US dollar LIBOR settings will continue to be published on a representative basis until 30 June 2023. For treasurers, the rapidly approaching end-of-year deadline is the one to be working towards.

"Treasurers need to have things in place by 31 December, there is no other option," explains Tarek Tranberg, Head of Public Affairs & Policy, European Association of Corporate Treasurers (EACT). "For example, in the sterling markets it is already strongly discouraged that companies take on new exposures that still reference sterling LIBOR, unless for risk management of existing positions in the derivatives market." he says. "The key expectation from the industry-led Working Group on Sterling Risk-Free Reference Rates for all market participants is that any new sterling derivatives that expire after the end of 2021, entered into after the recommended milestones, be based on SONIA [Sterling Overnight Index Average]."

Sea change ahead

The new risk-free rates are specifically designed to address the deficiencies in LIBOR that have led to its cessation. The key issue for treasurers to understand is that, as a result of this, the new rates are not a like-for-like swap with LIBOR because they function differently.

"As the LIBOR discontinuation deadline became clearer, the penny started to drop maybe a year ago for some treasurers about what this change to market risk-free rates actually means," notes John Byrne, CEO, Salmon Software. "It's a complete sea change in the way interest is calculated and, as treasurers are absorbing the scale of this change, they are much more focused on being prepared to deal with it."

Using LIBOR, treasurers would set their rate, usually two days before the start of the period, and calculate interest on a simple interest basis. Everything about the interest for that period is understood, including the interest rate, the amount, and the accruals, for example. Using SONIA, however, none of those details are known. For example, it isn't possible to calculate the interest on any loan for any period until the period has ended and until the lag period has expired. Every day, a rate will be published for SONIA, and the rate published on any given day is the rate that will be used as the daily rate for a future date that is determined by the 'lag period'.

Byrne explains: 'The lag period is the number of business days between today's date and the date used to determine the interest rate to be applied today. In other words, if the lag is five days, then the rate used is taken from the rate published five business days earlier. Treasurers also need to factor in that the lag period takes into account weekends and holidays."

Each successive day's interest rate is compounded to derive the interest amount for that day, or that set of days if weekends and holidays occur. Each day's interest is added up to get a total interest amount for the period. That total interest for the period combined with the capital value determines the derived rate for the period.

"All of the above can be applied on one of two conventions: a look back with observational shift or a look back without observational shift," continues Byrne. "With or without observational shift determines whether the days in the interest period are derived using the shift period or not. The total interest for the period, combined with the capital value, determines the derived rate for the period. Of course, that assumes that the capital value hasn't changed mid-period. If it has, then the complexities mount."

Impact on treasurers

With the main deadline of 31 December 2021 becoming tangibly close, treasurers should be ensuring they have identified any existing financial products they hold that are currently tied to LIBOR beyond that date. Anyone using one-month LIBOR will be essentially changing from one rate per period, known at the start, to 25 rates per period – taking weekends into account – that are not known until the end of each period, plus lag days.

"Consider a 10-year bullet loan with monthly interest settings," offers Byrne. "Using LIBOR there are 120 interest periods, but using SONIA, there are 3,000 mini periods. It is also worth noting that the recommendation for the interest calculation is to go out to 16 decimal places, but Excel calculates to only 14 decimal places. That limitation will significantly inhibit the ability to deal with this change for any treasurers using Excel."

That said, another TMS vendor says it has run some analysis and could see no reason why 16 decimal places were needed, even taking into account compounding. The Bank of England was approached for more information and clarification on this point but did not respond.

For treasurers who have significant portfolios of loans, investments, interest rate swaps, cross-currency swaps, or index-linked loans, the work involved on a rollover basis is enormous. Even if spreadsheet calculations did go out to 16 decimal places (and were found to be necessary), the manual nature of Excel is not adequate to handle the calculation of payments using compounded risk-free rates, which is significantly more complex than under LIBOR. More agile treasury systems, particularly those in the cloud, can provide better support with the transition.

"Sophisticated, reliable, flexible technology has supported isolating a company's exposure to LIBOR, migrating position and process from LIBOR to the replacement rates, and helping reduce the increased operational risk to the business arising from using the new rates in each region," says Adam Bridgewater, Product Owner in Risk, Kyriba. In addition, he notes, market methods and conventions have been regularly changing during the course of 2020 and 2021 and are set to continue to do so. Previously this would have required delayed or sequential upgrades of on-premise systems. Says Bridgewater: "The introduction of cloud-based technology has facilitated quicker development and rapid deployment of software into the hands of customers after the new standards have been introduced, allowing for better support of corporate treasury departments."

That support is much needed, as the lag time complicates matters further. The sheer

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volume of transactions alone increases the chances of errors in calculations. For publicly quoted companies that have to publish results and calculate accruals without knowing today's rate at the time, is potentially a huge challenge.

Byrne continues: "With LIBOR, treasurers could get the three-month LIBOR rate, know that it's x%, then calculate what their interest is and calculate the accruals. They can't do that now because they don't know what the rate is. They don't even know what the rate is for today, unless they look back five days, and then they have to wait until the end of the period to determine the interest. Treasurers are going to have loans ending this year, next year, ending in 10 years, that are all linked to LIBOR. This has to change."

USD LIBOR exceptions

As already noted, the FCA made clear in March that certain tenors of USD LIBOR would be continuing until 30 June 2023.

"The extension of USD LIBOR was solely to assist with 'tough legacy' positions, which should not cover the majority of positions," says Bridgewater. "All regulatory bodies such as the ARRC [Alternative Reference Rates Committee], Federal Reserve, FCA, and ISDA [International Swaps and Derivatives Association] have urged that the transition away from LIBOR should still occur by the end of 2021. The certainty provided by the FCA announcement should provide greater clarity to corporate treasurers and, while there should be no impact to corporate transition plans in relation to USD LIBOR, the temptation exists to delay migration and/or let trades maturing before 2023 to run off the books."

No matter how tempting that prospect may be, to ensure a standardisation of approach it makes sense for treasurers to approach the deadline for all LIBOR tenors as being at the end of this year in order to adapt to the new world of risk-free rates sooner rather than later.

Tranberg adds: "That longer deadline could reduce pressure on companies to renegotiate all of their contracts as they may be able to let some of their exposures run off. Lessening the renegotiating of contracts could possibly be helpful for some companies."

Consequences of missing the deadline

Those that miss the transition deadline face the potential of missing a payment or getting a payment wrong, so there is potential for reputational damage.

"If you're paying interest to somebody, you want to be sure that it is right," warns Byrne. "Treasury is a low-volume, high-value business, so these numbers are going to be big. There are trillions of dollars' worth of loans out there tied to LIBOR in some shape or form and come 1 January 2022, most of them have to be reset."

While treasurers can address all of the LIBOR exposures in their investment and funding documentation that they can identify, the prospect of additional, hidden exposures should not be ignored. Having a plan in place as to how to respond swiftly to such an eventuality is essential.

Tranberg says: "Treasurers probably will need to put contingency plans in place in case they have exposures that they didn't know about that might resurface on the first of January next year. If they're in the Eurozone then there are statutory fallbacks that the EU has put in place, but this is not the case in other regions, so treasurers will have to understand what is available to them from the regulatory side in every region relevant to them."

PITFALLS TREASURERS MUST AVOID IN THE LIBOR TRANSITION

Tips from Kyriba's Adam Bridgewater

- When migrating a treasury portfolio, the treasurer should aim to minimise the transfer of value away from the company. One method would be to value the positions immediately before and after a transition.
- Corporate treasury departments must take special care that conventions match between borrowing and derivatives. This should be taken into consideration when managing a portfolio of legacy trades on fallback rates and new transactions.
- In addition to the impact of conventions on the borrowing and the derivative on any associated hedge accounting, the timing of migration for each also needs to be carefully managed.
- Ensure that systems are sufficiently flexible to not only handle standard interest periods but also stubs, mid-period step-ups, and amortisations on risk-free rates.
- Where floors on LIBOR exist, it has commonly been seen in the market that any calculated credit adjustment is also incorporated into the level of the floor, either by including in the flooring of the compounded risk-free rate or a floor applied directly to the daily overnight rate used in the calculation.
- Be aware that the Alternative Reference Rates Committee (ARRC) has announced specific conventions for intercompany lending on the Secured Overnight Financing Rate (SOFR) that systems will need to be able to handle if they are adopted. Also be aware that intercompany lending using in-house banks may be impacted by the transition from LIBOR.
- Market data for more exotic instruments are not yet available, for instance cross-currency swaps, caps and floors.
- While EUR LIBOR is ending, EURIBOR is continuing for the foreseeable future alongside the Euro Short-term Rate (€STR), the replacement for the Euro Overnight Index Average (EONIA).

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