Ripple effect

The impact of moving away from Libor

The shift from Libor to an alternative risk-free rate will require considerable cost and effort, and the sooner the market takes action the better to reduce the risks associated with transition will be. Morrison & Foerster's Geoffrey Peck and James Schwartz discuss key topics, including the impact of the shift on market pricing and risk management models, the drawbacks in alternative rates, and the potential longevity of Libor once a mainstream alternative has been adopted

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What are the key challenges associated with moving from Libor to alternative benchmarks?

James Schwartz, Morrison & Foerster: Libor has been central to the financial system for decades and is the basis for trillions of dollars in financial products. Replacing it will involve numerous challenges and risks.

The initial question is: what will replace Libor? So far, market participants have agreed that overnight rates are the preferred option. However, there are complex questions about how overnight rates can be adjusted for use in contexts that have been historically dominated by term rates such as Libor.

Difficult questions stem from legacy Libor transactions that will remain outstanding beyond 2021, when regulators state their preference to no longer require banks to make Libor submissions.

Certain products may contain fallback language in case Libor is not available, but in many cases those fallbacks are intended to address temporary unavailability of Libor, not a permanent one. In other cases – such as in the derivatives context – contractual fallbacks seem unlikely to be helpful, meaning parties would be well advised to reach an agreement on what should happen when Libor is discontinued.

In either case, for legacy contracts the discontinuation of Libor raises the possibility of significant and disruptive value transfers, because whatever replaces Libor is unlikely to be its economic equivalent.

Do you anticipate Libor remaining 'alive' after 2021? Why?

Geoffrey Peck, Morrison & Foerster: While regulators have clearly stated their expectation that in 2021 Libor will be discontinued, year-end 2021 appears to be aggressive timing. Given the many legacy contracts that reference Libor and mature after 2021 – and the enormous amount of work still required to transition to a new benchmark – it seems reasonably likely that, one way or another, Libor will remain alive after that date. It may be that, to avoid a significant value transfer, the authorities will decide to keep it – or a placeholder for it – alive for some time while legacy Libor contracts are concluded.

Who do you think will be the first to move away from Libor?

Geoffrey Peck: The first movers away from Libor will likely be large global banks and other large sophisticated financial institutions with more operational resources to handle the transition. Derivatives dealers, in particular, may transition from Libor more quickly because they are accustomed to overnight discounting. Regional and small financial institutions are likely to follow next, and then other financial entities, and corporates and other end-users.

What are the drawbacks with the new risk-free rates (RFRs) sponsored by global regulators?

James Schwartz: The new RFRs are qualitatively – and quantitatively – different from Libor. They are overnight rates, unlike Libor, which is a term rate, an unsecured rate, and reflects a credit spread. The International Swaps and Derivatives Association (Isda) has published a consultation to determine the best way to adjust overnight rates to make them work in the context of the derivatives markets, and there certainly are complexities. In addition, liquidity needs to be built into the new benchmarks for them to play the role envisioned for them.

It is important to bear in mind, however, that the new rates have a major strength that Libor has lacked in recent years reflecting large numbers of actual, observable transactions. Whatever drawbacks there may be in the new rates, they will not have some of the deep weaknesses that Libor has exhibited in recent years.

Will some participants be unlikely to ever move away from Libor?

Geoffrey Peck: The regulators have stated that Libor will be discontinued, so at a certain point there will presumably be no choice in the matter. But it seems likely that certain market participants will continue to transact based on term rates other than Libor.

A subset of market participants, which can be loosely described as end-users, will likely wish to continue to use term rates, both for economic and operational reasons. For example, a recent consultation in the UK found

that there would be strong demand for term rates in relation to corporate lending and securitisation structures, and medium demand for term rates in relation to retail loans, mortgages and floating rate notes.

How safe a benchmark is Libor today?

Geoffrey Peck: Institutionally, Libor is at present a fragile benchmark. There are so few actual unsecured interbank lending transactions that an interbank offered rate (Ibor) is arguably a fiction. Given the importance of the benchmark, the regulators are correct to seek replacements.

However, Libor's centrality to the financial system means the regulators would do well to assure the market of its continuing safety while the market transitions to new benchmarks. There is no telling what the Libor curve could look like, or how it could move, if the regulators were to announce a near-term date on which Libor is to be abolished. Perhaps the safest route might be to forbid the use of Libor in new transactions while keeping alive a synthetic Libor curve, perhaps derived from historical data, for legacy transactions.

Is there enough time to move the industry away from Libor before the end of 2021?

James Schwartz: The consensus is that, to move away from Libor before the end of 2021, the pace of the transition must accelerate dramatically. Liquidity needs to be built into products referencing the new RFRs. In addition, most market participants either have not mobilised a transition programme or have had only initial internal discussions about the transition. Relatively few have allocated budget and other resources to a Libor transition plan.

Unfortunately, given the uncertainties in this transition away from Libor, up to this point it has been tenable, if perhaps not advisable, to take a wait-and-see approach. If the Isda consultation on the RFRs reaches durable consensus, that could change quickly.

What will be the impact of the move away from Libor on market pricing and risk management models?

James Schwartz: Libor continues to represent an important basis for pricing and risk management, even after the [most recent] financial crisis, when certain derivatives dealers began discounting collateralised swaps at an overnight rate. The move away from Libor, from the standpoint of pricing and risk management, will require significant resources and co-ordinated efforts across risk, pricing and operations.

A central part of the effort will involve constructing new term interest rate curves, fundamental for valuing future cashflows, based on the RFRs. So far there is no consensus, however, on the methods for building those curves and how an overnight rate is to be projected onto a term rate. ■