

Transition from IBOR to Alternative Reference Rates - Implications and Roadmap

Traders Magazine Online News, August 20, 2018

Paminder Bansil and Vivek Agarwal

[Printer Friendly](#) |
 [Email](#) |
 [Reader Comments](#)

[Tweet](#) |
 [Share](#) |
 [Share 4](#) |
 [G+](#)

Virtually every bank that participated in the recent ISDA IBOR Global Benchmark Transition survey, expressed concern about their organization's level of exposure to IBORs. It's easy to see why. Contracts referencing IBORs have hundreds of trillions of dollars in notional of derivatives in addition to trillions of dollars in other contracts. These contracts cover a wide range of financial products, including OTC and exchange-traded derivatives, loans and deposits, bonds, repos, commercial papers and securitized products. The transition from IBOR to ARR will impact almost all participants in financial services including investment banks, asset managers, commercial banks, exchanges, custodians, central clearing counterparties (CCPs), Reference data vendors to name a few.

Use of IBORs has been on the decline for a number of reasons. Firstly, the level of interbank borrowing itself has reduced drastically. Based on the FRED website, interbank borrowings declined from a peak of almost half a trillion dollars in 2008 to around seventy million by the end of 2017. Secondly, banks prefer to use market observable rates such as those from overnight interest rate swaps. This eliminates any subjectivity inherent in a survey based rate. Thirdly, alternative reference rates (ARRs) are readily available, such as SOFR, SONIA, TONAR and SARON in the US, UK, Japan, and Switzerland respectively. Lastly, UK's Financial Conduct Authority (FCA) announced that it will no longer require panel banks to provide survey inputs for Libor calculation after 2021. For these reasons, the sustainability of IBORs is highly suspect.

Implications

Non-availability of IBORs and transition to ARR will have serious implications for financial institutions. These implications span valuation and risk management, contract terms, and asset class and currency specific processes. Implications will be further compounded due to the timing of this transition:

Valuation models and risk management approach may need to be reviewed and updated given the fact that the calculation of ARR is very different from how IBORs are arrived at. Additionally, while IBORs are unsecured, most ARR are collateralized. These differences change the risk profile. While ARR are typically lower than corresponding IBORs, they could have different levels of volatility and impact the economics of the trade referencing IBOR and moving to ARR.

Many contracts have fall-back provisions pre-empting the possibility of short-term unavailability of IBORs to ride over the brief period of unavailability of IBORs with limited losses or gains. However, unavailability of IBOR for the remaining life of the contract is unlikely to be addressed in a fall back clause and can leave firms with a significant exposure.

The complexity of transition from IBOR to ARR will depend upon the asset class and currency in question. Derivatives contracts in the US may be ahead of the curve given groundwork being done by ISDA on standardizing contracts and Fed for providing a robust and transparent ARR. Something like a highly customized syndicated loans contract executed in Euro may take a little longer to transition.

There is uncertainty around when the transition to ARR will actually take place. Further, the transition is not likely to be coordinated across different currencies. This will mean that financial institutions will need to support IBOR and ARR in parallel for a substantial period. Contracts referring to more than one currencies may also need to be broken up by currencies due to this issue.

The recommended approach to migration



THE RIGHT PARTNER FOR
 PROFESSIONAL TRADERS AND
 BROKER DEALERS WHO
 REQUIRE EFFICIENT, INNOVATIVE,
 TECHNICALLY ADVANCED

RELATED ITEMS

Articles from this Site

- ▶ [BondWave Unveils New User Interface for PMP Solution](#)
- ▶ [Treasury Trading Evolves with Bilateral Streaming](#)
- ▶ [The Case for Investment Grade Bonds](#)
- ▶ [Treasury Market Eyes Aggregated Streams](#)
- ▶ [Buy Side Juggles Efficiency and Workflow in Search for Corporate Bond Liquidity](#)
- ▶ [More Articles from this Site](#)

MOST READ | MOST EMAILED

[The Layman's Guide to Bitcoin and the Blockchain.](#)

[SEC's Redfearn Makes Statement on CAT Development, Delays and Implementation](#)

[Global E-Trading Growth Shifts to High-Yield and Cash Equities](#)

[QUICK TAKE: Crypto Mart Downturn Will Thin Herd](#)

BrokerTec

NEX Data

Two-thirds of the participants in the ISDA survey mentioned in the opening of this article did not know their roll off profile. That is, they did not know the amount tied to contracts that refer to IBOR and will not expire by 2021. This is a fundamental information that financial institutions need before they can create a remediation plan. The nature and size of the impact are also likely to vary significantly by contract. So, as a first step, financial institutions should do an assessment of their contracts to quantify potential exposure by currency, geography, business line, and customer groups.

Once institutions know the impact, they will know which ones will live beyond 2021 and carry significant exposure. Such contracts may need to be renegotiated. This will be an exercise of mammoth proportion given a typical timeline of three to six months to negotiate a contract and thousands of contracts that will need to be rewritten. There are several options available to financial institutions to ride over this surge in the repapering effort. If an institution believes their business-as-usual process is fine and they need help just to get over the surge, they could simply outsource it. If financial institutions see this as an opportunity to update their existing process, they could consider improvements like implementing a web-based collaboration platform to speed up negotiation, use Artificial Intelligence tools to improve the digitization and build interfaces to update downstream systems in real time.

Apart from the business changes, there will be technology and process changes across front, middle and back office. This will include new and updated pricing and valuation models, review and update of controls, new reference data feeds, changes in data provisioning systems, changes in accounting, new reconciliations to name a few. Setting up a consulting program to review the existing infrastructure to create a prioritized book of work will be a good starting point.

Summary

In summary, IBOR is looking increasingly shaky and its long-term availability is suspect. The transition from IBOR to ARR will be complex, protracted and very resource intensive. This complexity is due to changes necessary in valuation and risk management, the robustness of contract terms, asset class and currency in question. The difference in timing of transition in different geographies will further complicate the problem. Advice from regulators and industry bodies is to start early. Financial institutions should be setting up programs starting with defining and quantifying the problem, updating valuation and risk management models, prioritizing contracts that will be impacted, revalidating controls and analyzing changes necessary in the IT infrastructure.

Parminder Bansil is Head - Securities and Capital Markets Consulting unit, BFSI strategic business unit, Wipro Limited.

Vivek Agarwal, Partner- Securities and Capital Markets Consulting unit, BFSI strategic business unit, Wipro Limited.

[previous](#) [1](#) [2](#)

For more information on related topics, visit the following channels:

- [Fixed Income](#)

COMMENTS (0)

Be the first to comment on this post using the section below.

Add Your Comments:

AND TECHNOLOGICALLY ADVANCED
CLEARING SOLUTIONS

RELATED ITEMS

Articles from this Site

- ▶ [BondWave Unveils New User Interface for PMP Solution](#)
- ▶ [Treasury Trading Evolves with Bilateral Streaming](#)
- ▶ [The Case for Investment Grade Bonds](#)
- ▶ [Treasury Market Eyes Aggregated Streams](#)
- ▶ [Buy Side Juggles Efficiency and Workflow in Search for Corporate Bond Liquidity](#)
- ▶ [More Articles from this Site](#)

MOST READ | MOST EMAILED

[IT Spending Remain Robust -- For Now](#)

[FLASHBACK FRIDAY GALLERY: 15th Annual Canadian Security Traders Association](#)

[SEC's Redfearn Makes Statement on CAT Development, Delays and Implementation](#)

[Banks Boosting Ethics on the Trading Floor, Fonetec Says](#)