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# *Discontinuation of LIBOR – are you ready?*

### *Discuss more?*

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## *What happened so far?*

*The Chief Executive of the UK's Financial Conduct Authority (FCA), Andrew Bailey, delivered a speech on 27 July 2017, stating that the London Interbank Offered Rate (LIBOR) will be phased out by 2021. He urged the sector to work in earnest on developing alternative reference rates based on actual transactions.*

*In his speech, Bailey indicated that the FCA wishes to achieve a position by the end of 2021 where transaction-based alternatives are available and "it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR."*

*The decision of FCA not to maintain LIBOR any longer is definitely a massive change in the interest rate area that will affect the financial services industry in various areas.*

## *First implications following the announcement to phase out LIBOR at the latest by 2021*

Following the lead of the FCA on 21 September 2017 the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA), the European Central Bank (ECB) and the European Commission announced the launch of a new working group tasked with the identification and adoption of a risk-free overnight rate which can serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the eurozone.

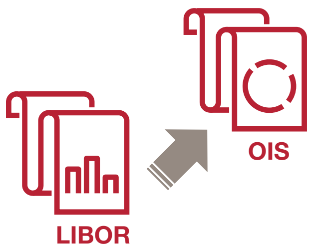
## *The discontinuation of LIBOR: a paradigm shift for the banking industry*

Since securities of more than $350 trillion are underpinned by LIBOR, its discontinuation will initiate a major change in the banking industry:

- In the short term, it is currently unclear how contracts with an expiry date later than 2021 will be settled when the underlying benchmark does not exist anymore.
- In the long term, choosing OIS curves as a successor to LIBOR could be problematic as the market volume has been steadily shrinking since 2008, making it difficult to use it as a benchmark.
- Considering the large spread between LIBOR and the most probable successor OIS since 2007, there is potential risk of a cliff effect in valuation of mortgages, credits and bonds.

The LIBOR-OIS spread is seen as the level of reluctance of an investor to deposit for an AA-rated bank, in comparison with a risk-free investment, i.e. the LIBOR-OIS spread is a measure of the bank credit spread, term liquidity spread, and term risk premia for interbank loans. This spread is a closely monitored barometer of the health of the banking.

**What is LIBOR?**
LIBOR is the average of short-term borrowing rates estimated by each of the leading AA-rated financial institutions in London. Before 2007, LIBOR was seen in practice as a proxy for the risk-free rate.




**What is OIS?**
Overnight indexed swaps are interest rate swaps in which a fixed rate of interest is exchanged for a floating rate that is the geometric mean of a daily overnight rate.

## *Changing curves: what is the alternative?*

Nevertheless, the Overnight Indexed Swaps (OIS) rates are seen as the most appropriate risk-free alternative for LIBOR in practice since the floating payments of an OIS are equivalent to daily compounded overnight investments, i.e. investments that are considered as nearly risk-free due to their extremely short term (less than one day). More explicitly, the most considerable alternatives are:

- Overnight index averages like EONIA, SONIA, SARON, SOFR and TONAR may serve as adequate, nearly risk-free alternatives.
- Switzerland is already replacing its benchmark rate, TOIS, with the overnight alternative, SARON.

| Jurisdiction | Reference benchmark | Proposed replacement rate | Borrowing type |
|---|---|---|---|
| US (USD) | USD LIBOR | SOFR *(June 2017)* | Secured |
| UK (GBP) | GBP LIBOR | SONIA *(April 2017)* | Unsecured |
| Switzerland (CHF) | CHF LIBOR | SARON *(leading candidate)* | Secured |
| Japan (JPY) | JPY LIBOR | TONAR *(June 2016)* | Unsecured |
| Euro (EUR) | EURIBOR | EONIA *(leading candidate)* | Unsecured |

Proposed tenor: overnight target implementation date: January 2022; source: PwC USA

# *Discontinuation of LIBOR – change as an opportunity!*

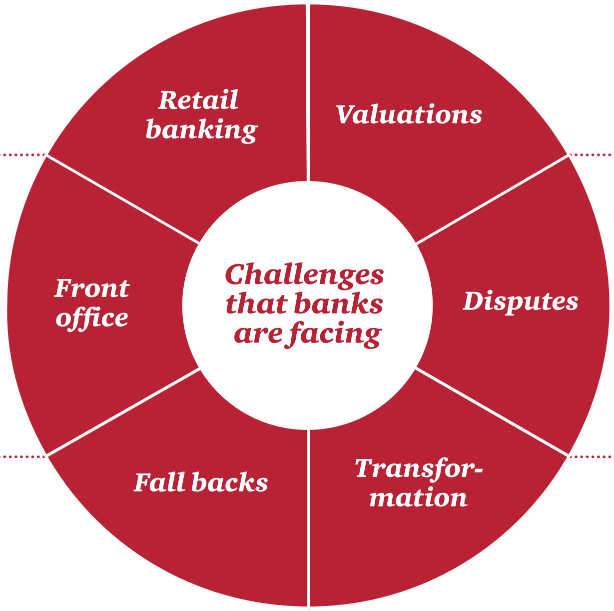
## *Key challenges in replacing LIBOR*

***Revision of mortgage contracts***

- LIBOR-referencing contracts must be revised
- Strong requirements on substituting contracts

***Change of valuations required***

- LIBOR cannot be used for valuation of financial instruments, most notably derivatives, real estate and securitisation
- Cliff effect in P&L must be mitigated




***Front office***

- The front office must refrain from issuing new LIBOR-referencing contracts
- Preparation of clients regarding paradigm shift.

***Systemic aspect of disputes***

- No clarity around how extant contracts will be managed
- Market disruption caused by the discontinuance of LIBOR without having appropriate transitional arrangements

***Fallback options***

- Derivatives: amendments, including changes to ISDA masters, may need updating
- Corporate lending: parties need to consider building in flexibility to amend interest rate determination provisions
- Debt and floating rate securities: issuers/trustees should consider how a replacement rate could affect noteholder interests

***Smooth fade out***

- LIBOR could continue beyond 2021, but the regulator's move is aimed at a large shift onto a new metric for the wider market
- Counterparties will need to bilaterally agree how to deal with transactions that reference LIBOR rates
- Determine how to best minimise basis risk within any given currency and develop approaches for managing cross-currency basis risk for varying rates

***Next steps:*** market participants must precociously begin to consider the effects the introduction of new benchmark rates has on their portfolios and systems. Viable interest rates have to be developed and their impact analysed early on to ensure a smooth transition away from LIBOR.

# Why PwC?

## Relevant regulatory and business expertise

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- We leverage our prior experience in model design, development, implementation, documentation and validation.
- We have deep experience in products and relevant market areas of the banking sector.

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## In a nutshell: brief history of LIBOR

**1970**

LIBOR as a contractually defined term was developed to facilitate loan transactions.

**1986**

The development of LIBOR was further driven by the growth in new financial instruments which also required standardised interest rate benchmarks, which were developed in the 1980s and administered by the British Bankers' Association (BBA) through BBA LIBOR Limited and published as BBA LIBOR.

**2011**

The LIBOR scandal, one of the biggest scandals in history, yielding to fines of $9 billion, undermines the trust in the fixing.

**2012/2013**

LIBOR rates are completely discontinued for various currencies, most notably AUD and CAD. LIBOR is comprehensively reformed in accordance with the ten point plan contained in the Wheatley Review.

**2017**

Andrew Bailey, head of FCA, stated that there was not enough meaningful data to sustain the benchmark. After 50 years as the global benchmark of borrowing rates, **LIBOR will be discontinued at the end of 2021.**

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