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Interest rate benchmark reform

Why asset managers need to prepare for LIBOR replacement

November 2018

Building a better working world

IBOR transactions will impact the buy side as contracts worth US$350 trillion use LIBOR as a benchmark.

> With approximately US$350 trillion worth of contracts using LIBOR as a benchmark rate, the IBOR transition will have a huge impact on you, your counterparts and clients over the next three years.

IBOR transition: the portfolio changer

The London Inter-bank Offered Rate (LIBOR) benchmark is used by a number of funds and fund managers as a reference rate for portfolio construction, agreeing terms with investors, and calculating returns on existing or new investments. For asset managers, the LIBOR fixing scandal, followed by the G20 countries' request for reform of major interest rate benchmarks, i.e., Inter-bank Offered Rates (IBORs), will have widespread business implications.

Financial markets as a whole have been seeking a workable solution to changing contracts worth trillions globally that use the LIBOR benchmark. Proposals have included an enhancement of existing IBOR benchmarks, as well as developing and transitioning to Alternative Reference Rates (ARRs), which are nearly risk-free rates (RFRs) that could be used instead of IBORs.

Multinational banking institutions on the sell side have been preparing for IBOR transition across several jurisdictions, market segments and products. This trend has picked up in 2018 as alternative RFRs have been established. More recently, traders and portfolio managers at asset management institutions have been enquiring about the banking system readiness to inform the buy-side response.

While market awareness of this IBOR transition has been relatively low outside of the large multinational banking institutions, buy-side firms are starting to realize the breadth of the change and the extent of senior leaders' involvement required in the coming months. LIBOR is embedded in floating rate instruments, and forms the foundation of interest rate swaps and futures. Understanding impacted products and contracts, as well as the changes for investors is the focal point for a smooth transition.

What has happened so far?

Working groups in different jurisdictions (UK, US, the EU, Switzerland and Japan) have recommended alternative RFRs as interest rate benchmarks for their respective jurisdictions to transition away from existing IBORs. These RFR benchmarks are predominantly overnight, whereas current use of IBORs is largely for term rates. A survey conducted by the International Swaps and Derivatives Association (ISDA), published in June 2018, showed that 24% of market participants intend to enter into new contracts with alternative RFRs within a year. Seventy-eight percent the of survey participants intend to use alternative RFRs within the next four years.

The EU Benchmarks Regulation, which went live in January 2018, introduced a common framework and consistent approach to the use of benchmarks across the EU. Where asset managers use IBORs or alternative RFRs as a benchmark in the EU, they must comply with this regulation.

> Geographies and market participants are gearing up to act more autonomously post LIBOR.

In the UK, the reformed Sterling Overnight Index Average (SONIA) was recommended as the near risk-free interest rate benchmark. This recommendation was largely due to the existing market for SONIA-linked swaps already in place, where SONIA is based on actual transactions. Infrastructure providers are beginning to clear products referencing the reformed SONIA, with futures and swaps already trading.

Alternative RFRs are core to firm-wide valuation and risk measurement models and infrastructure. The IBOR transition will impact all existing positions that reference LIBOR. Risk management mechanisms will be required to mitigate potential pricing variations and value transfer uncertainty.

Areas impacted

Early considerations of the IBOR transition has identified a number of cross-business implications. These challenges include data, technology infrastructure, treasury, accounting, legal, tax, regulatory compliance, controls, governance and oversight. These are in addition to the obviously exposed areas of product, portfolio management and distribution. Most functional areas within the front office, middle office and back office will be impacted, and the extent of changes mean a significant shift in management focus.

Do you have visibility of the different parts of your operating model that utilize LIBOR?

- Reformed SONIA
- Secured Overnight Financing Rate (SOFR)
- Euro Short Term Rate (ESTER)
- Swiss Average Rate Overnight (SARON)
- Tokyo Overnight Average Rate (TONAR)

Product

The scope and size of IBOR currencies (e.g., USD, GBP) and tenors (e.g., overnight, term) referenced by product type will mean a complex impact for contracts linked to alternative RFRs. The challenges include:

- Limited standardization in contract and fallback language.
- Lack of industry protocols on contract language.
- Need for extensive client education and outreach.

Legal

- Contract amendments (volume and complexity) and client outreach are anticipated to be among the main legal challenges. The transition may involve high litigation, reputation and conduct risks for asset managers.

Valuation and risk management

IBORs are extensively used as a proxy risk factor for discount factors across a range of financial and risk models, and a transition without a historical time series may pose challenges. The challenges include:

- Balance sheet, profit and loss, and risk exposures may be impacted and pro-forma analysis may be required to inform transition strategies.
- Potential pricing variations and value transfer uncertainty need to be mitigated, and changes to valuation arrangements need to be addressed.
- Impacts on risk appetite and desk and portfolio limits need to be assessed and risk reports have to be updated.

Operations, data and technology

IBORs are embedded in processes, data and application environments. Significant changes are expected across processes and infrastructure.

Governance and controls

Individual transactions should be reviewed to identify legal requirements. Robust cross-functional governance models should be defined to oversee transition efforts and modifications to existing control frameworks.

Market liquidity and uncertainty

RFRs may differ in relation to availability and liquidity in derivatives markets. This is relevant to monitor because:

- The availability of RFR term rates is dependent on the liquidity in the RFRs' derivatives markets.
- Mismatches may also arise on cross-currency hedges across jurisdictions.

Enterprise risk and regulatory compliance

A lack of explicit guidance, legal certainty and prudential incentives from the regulators may cause delays in transition. Potential regulatory implications cross-dependencies with current regulatory requirements, such as internal capital adequacy process (ICAAP).

Accounting and tax

- Policy, process and system changes are required to enable application of the alternative RFRs to the current accounting frameworks.
- Potential impacts on hedge accounting, valuation differences and the need to consider new benchmarks being hedged may arise.
- Downstream impacts on taxation may involve revaluation of tax assets and liabilities, potentially resulting in acceleration of payments.

So what's next?

While IBOR transition presents a number of challenges, there are ample opportunities for asset managers along the way. These include taking the opportunity to upgrade IT systems; streamline processes, data technologies and infrastructure; target new clients; update and clarify investment literature and prospectuses; drive standardization in contracts and fallback language; and enter into new hedging instruments.

> The impact assessment is the bedrock by which asset managers can begin to understand the key challenges and considerations associated with the IBOR transition.

Awareness across the asset management industry is starting to pick up, but lags behind the sell side. It is important that asset managers start to consider the impact across their operating model. They should:

- Consider the breadth of IBOR usage across products and financial contracts, prioritize the investment mandate needs and evaluate liquidity impacts accordingly
- Assess the depth of impacts on risk and pricing models, processes and hedging strategies

The key to an effective transition will be a robust governance structure in management companies and across fund boards in order to oversee the coordinated design and implementation of IBOR transition efforts across portfolios. Governance should be under the control of the fund boards and implementation must be led by asset managers.

To discuss how EY can help you prepare for IBOR transition, please contact

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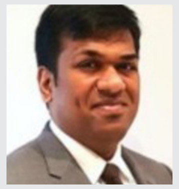

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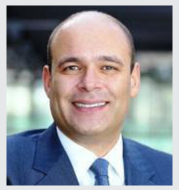

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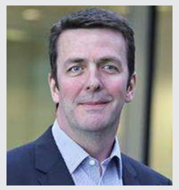

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