

# COVID-19 and LIBOR Transition: Taking a Market-led Approach

Banking & Financial Services



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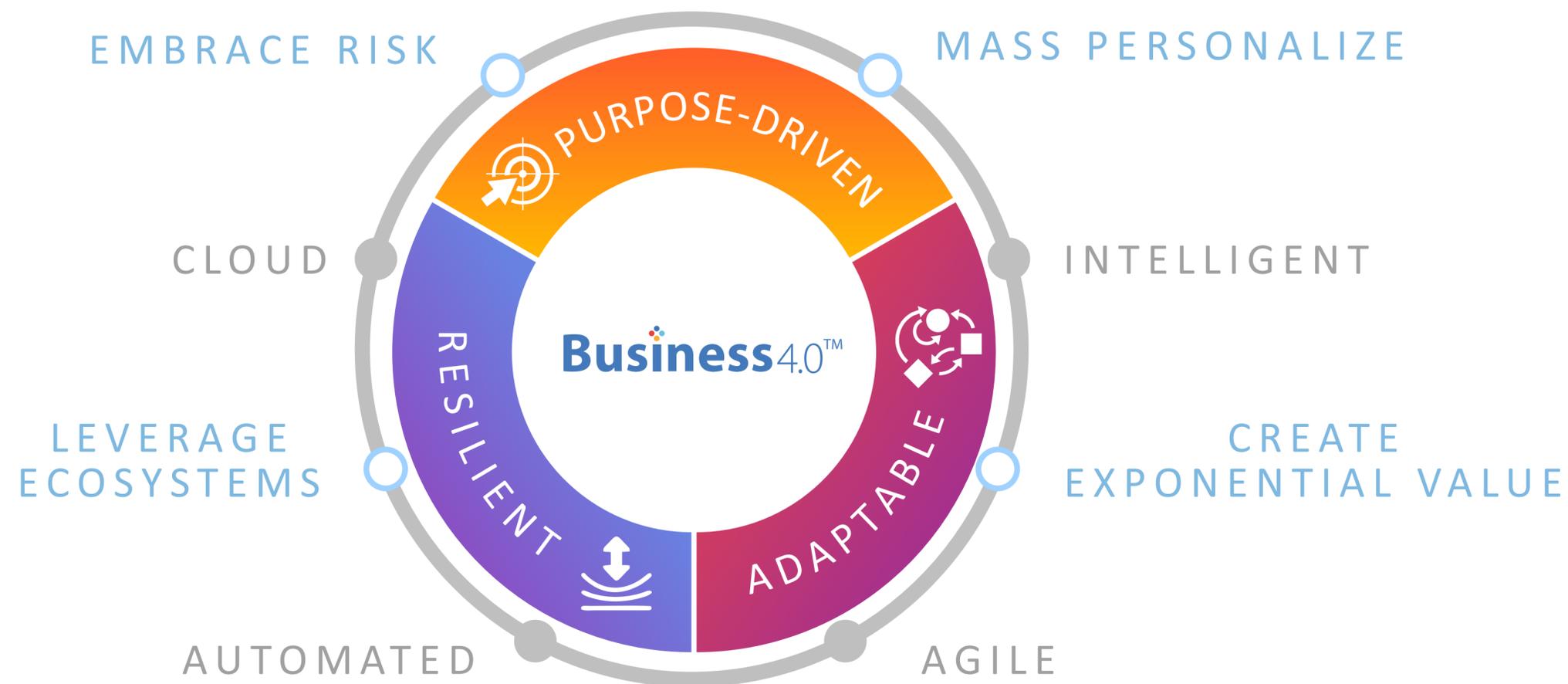
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## Abstract



The ongoing COVID-19 pandemic has caused severe market volatility globally. Despite this volatility, the US Federal Reserve, Bank of England (BoE), and the Financial Stability Board (FSB) have reiterated their stance on firms not relying on LIBOR post December 31, 2021. This white paper examines regulatory pronouncements with regard to COVID-19 impacts on LIBOR transition plans and recommends how financial institutions must continue LIBOR project execution, in parallel with their business-as-usual activities.



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# Recent Regulatory Statements

There has been a raft of regulatory statements across the financial services industry. While regulatory initiatives such as the Standard Approach to Credit Risk (SACR) and the Fundamental Review of the Trading Book (FRTB), et al. have been delayed (see Table 1), the elephant in the room is the LIBOR transition where the original implementation deadline of January 1, 2022, remains unchanged.

Standard	Original Implementation Date	Revised Implementation Date
Revised leverage ratio framework & G-SIB buffer	Saturday, January 01, 2022	Sunday, January 01, 2023
Revised standardised approach for credit risk	Saturday, January 01, 2022	Sunday, January 01, 2023
Revised operational risk framework=	Saturday, January 01, 2022	Sunday, January 01, 2023
Revised CVA framework	Saturday, January 01, 2022	Sunday, January 01, 2023
Revised market risk framework	Saturday, January 01, 2022	Sunday, January 01, 2023
Output floor	1 January 2022; transitional arrangements to 1 January 2027	1 January 2023; transitional arrangements to 1 January 2028
Revised Pillar 3 disclosure framework	Saturday, January 01, 2022	Sunday, January 01, 2023

*IRB = internal ratings-based approach; CVA = credit valuation adjustment*

Table 1: Revised Timelines for Upcoming Regulations Amid the COVID-19 Pandemic



Regarding LIBOR transition, the Financial Conduct Authority (FCA), BoE, and the members of the working group on Sterling Risk-Free Reference Rates (RFRs) have issued a joint statement on the impact of coronavirus on banks' LIBOR transition plans<sup>1</sup>, which says:

- "...end of 2021 ...should remain the target date for all firms to meet."
- "...preparations for transition will be able to continue. There has, however, been an impact on the timing of some aspects of the transition programmes of many firms".

Note the language around this being a 'target' date. While the statement reiterates that transition should continue, it is contradicted by the statement around partial impact on implementation. In fact, industry experts opine project resources are being diverted to support ad hoc business-as-usual activities across business and technology functions.

- "...segments of the UK market...made less progress in transition and are therefore still more reliant on LIBOR, such as the loan market..."

The statement acknowledges that certain lines of business within institutions have made less progress, which is a positive development.

Similarly, the Federal Reserve Alternative Reference Rates Committee (Fed ARRC) has acknowledged momentum and urged that balance should be maintained in delivering the transition in these challenging circumstances.<sup>2</sup>

[1] Financial Conduct Authority, Impact of the coronavirus on firms' LIBOR transition plans (Mar 2020), accessed May 10, 2020, <https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans>

[2] Federal Reserve Bank of New York, Alternative Reference Rates Committee (ARRC) Minutes for the March 20, 2020 Meeting (March 2020), accessed May 10, 2020, <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2020/ARRC-Minutes-March-2020.pdf>



## Impact of Market Volatility on LIBOR Transition

The COVID-19 crisis has impacted all asset classes, even resulting in assets being simultaneously liquidated.

Several global currencies have a Forward Rate Agreement (FRA) based on 3M LIBOR – overnight indexed swap (OIS) spread, which is seen by many as a proxy for risks in the banking sector. The OIS is effectively the RFR. The FRA-OIS spread has significantly widened, proving the criticality of LIBOR and its use as a proxy to ascertain funding, term premium, bank credit, and overnight rate risks. The excessive widening of the basis in stressed times is one of the main reasons behind the move to replace LIBOR.

Funding pressures are now being addressed by central banks, by the Federal Reserve in the US, the BoE in the UK, and the European Central Bank (ECB) in the European Union, where their respective balance sheets have been ramped up significantly.

With Fed funds at near-zero levels and 3M USD LIBOR at an all-time high, at the end of March 2020, driven mainly by increase in commercial paper rates, basis has significantly widened. Institutions are currently analysing the basis to understand impacts across their respective lines of business.

The impact on the Secured Overnight Financing Rate (SOFR) is at a critical turning point. Despite the COVID-19 crisis, the RFRs are not exhibiting the volatility seen in the LIBOR market. Whilst repo markets are not showing funding stresses seen in the past (such as the September 2019 SOFR spike), SOFR is trading in the range of 0.01% to 0.03%.<sup>3</sup> From a Sterling perspective, the Sterling Overnight Index Average (SONIA) is not exhibiting negative rate characteristics for now.

[3] Financial Conduct Authority, Impact of the coronavirus on firms' LIBOR transition plans (Mar 2020), accessed May 10, 2020, <https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans>

# What Financial Institutions Must Do

Given the volatility caused by COVID-19, financial institutions need to reassess several aspects that are intrinsically linked, update the product and rates strategy, and link this to technology activities such as exposure dashboard analysis and legal contract management.

## Rates strategy

Considering the complexity of the transition and the need to understand institutions' exposures, product inventory, and client cohorts, a rates strategy should be developed. Given that RFRs such as SOFR and SONIA are at near-zero levels, institutions will be aware that margins will need to be maintained, especially in a low interest rate environment with capital management constraints.

In parallel, RFRs such as SOFR are moving south due to the COVID-19 induced volatility, and impacting the ALM process where the liability pricing process includes a credit sensitive component. ALM mismatches need to be managed carefully as credit spread sensitivity is not incorporated into RFRs. The industry is currently investigating alternative rates with unsecured and term characteristics such as the American

Interbank Offered Rate (AMERIBOR) and the Intercontinental Exchange Bank Yield Index (ICE BYI). In parallel, quantitative analysts are investigating how to replicate concepts such as OIS and credit default spreads (CDX) by sector and offer them as products. In addition, the industry is looking at how forward-looking term rates can be built for the loans market.

When interest rates do rise, institutions will have to adjust their spread above the government cost of borrowing to factor in the risk of borrowing, triggering inflation as well as the devaluation of currencies in which they will be repaid. Banks must use the LIBOR transition to establish an institutions rates strategy.

## Exposure dashboard analysis

Institutions will need to analyze the change in exposures per asset class and clearly demarcate the back book (trades maturing prior to December 2021) and front book (trades maturing post December 2021). Given that institutions and their clients will be at different points in the transition for each currency, there will be instances where LIBOR related exposures increase as RFR markets are still not liquid across



the full curve. This should be closely monitored by the management and LIBOR related exposures should be discouraged.

Institutions should understand how their respective revenue generating functions are using the LIBOR and RFR curves to price their products. In parallel, banks must analyze how their respective treasury funding processes around funds transfer pricing (FTP), cost of funds (COF), and asset-liability management (ALM) have performed under RFR and LIBOR. The same analysis should be extended to hedging products as well.

## Product strategy

Institutions must reassess their product inventory to understand the impact of COVID-19 volatility and LIBOR-RFR movements on performance. Categorizing by cash, linear, and non-linear products, each product subset will need to be analyzed to understand the impact on desk and enterprise risk and finance and operational metrics such as P&L, X-value adjustment (XVA), value at risk (VaR), and risk weighted assets (RWA).

The transition is further complicated by products using an assortment of conventions per RFR. Moreover, the absence of a standard convention (compared to LIBOR's simplicity) increases the complexity in technology implementation, the parallel run for products and the respective desk and/or enterprise risks, and the calculation of finance and operational metrics.

## Legal contract management

Given that LIBOR is a rate that has been in use for 40 years, it is critical that financial institutions appropriately tailor their communication for different client segments (small and medium enterprises, micro enterprises, and large corporations). Segmenting the client base will help draw up a systematic transition plan that benefits clients as well as financial institutions. Whilst central banks have remained silent on this issue, the BoE has made potential suggestions on how products could be mapped to client cohorts. However, we expect further regulatory guidance on this as the transition progresses. With clients accessing emergency funds from central banks due to the COVID-19 crisis, it is vital that institutions are clear on this mapping to ensure optimal utilization of resources, time, and funds.

The recent market volatility will have tested the product offerings, especially in the loans market, where there are significant challenges in moving to backward-looking rates. Alternative rates such as the ongoing development of USD and GBP term rates for markets as well as rival rates such as AMERIBOR and ICE BYI that may be better suited for regional banks must be explored.

Considering that LIBOR transition programs are ongoing and evolving, they require a high degree of planning and the agility to respond to shifts. In addition, given the fluid situation, banks may not be able to address all concerns immediately. To ensure a seamless and orderly transition, given the extreme situation, financial institutions must:

- Engage with their boards and understand the strategy that is now being employed
- Communicate COVID-19 impact on scope, data, and project plans throughout the organization
- Collaborate with lines of business to understand the COVID-19 impact of the change in scope and the likelihood of new or amended deliverables with new timelines
- Utilize governance frameworks to engage across the organization and estimate the total delta
- Re-plan and partner with technology service providers on prioritizing key end-to-end deliveries across the stack



## Looking Ahead

The importance of LIBOR transition cannot be underestimated. However, the challenges emanating from the ongoing COVID-19 crisis is resulting in a shift in the overall regulatory and markets landscape in turn impacting LIBOR transition programs. Whether the timeline will be extended will depend largely on how the COVID-19 situation evolves over the next few months. An orderly and systematic movement to new RFRs is imperative; a rushed disorderly transition will severely disrupt a market already weakened by the pandemic. Financial institutions must therefore proactively take steps to update product and rates strategies, revisit delivery plan across business and technology, assess the impact on trading systems, risk architecture and vendor contract management, and reevaluate interim milestones based on client feedback and regulatory pronouncements on LIBOR transition.



# About the Authors

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