LIBOR Transition: Leveraging Digital Technologies for Seamless Migration

Abstract

The UK's Financial Conduct Authority (FCA) has announced the discontinuation of LIBOR with effect from January 1, 2022.[1] In response, various countries have adopted alternative rates such as the Secured Overnight Financing Rate (SOFR), the Euro Short Term Rate (ESTER), the Sterling Overnight Indexed Average (SONIA), the Swiss Average Rate Overnight (SARON) and the Tokyo Overnight Average Rate (TONAR).

The transition of financial contracts worth about $400 trillion that reference LIBOR will have a major impact on banking, financial services and insurance (BFSI) firms.[2] Financial instruments such as derivatives, loans, floating rate notes (FRNs), repos and securitized products will have to undergo significant system level changes. In our view, efficient and timely LIBOR transition will require business impact assessment and adoption of digital technologies along with regulatory knowledge. This paper highlights the impact and discusses the digital enablers that banks can implement to address the various operational and business challenges.

LIBOR Transition: Evaluating the Impact

Considering LIBOR transition as mere replacement of data is a simplistic view; in reality, the transition to risk free rate (RFR) is much more complex. During the transition phase, banks will need to focus on two levels of change — first, the existing contracts with maturity dates beyond 2021 will have to be closed and a new position linking the new RFR will need to be opened and, second, all the affected applications will need to be enhanced to accommodate the changes to support new RFR products and processes. The transition will also affect market operations including the trading desk, risk, valuation, collateral management, contract management, margining, settlement, hedge accounting and, reporting.

To ensure an orderly transition, banks must adopt an agile approach in the areas of impact assessment across products; LIBOR exposure analysis; evaluation of changes required for impacted applications; developing appropriate fallback language; ensuring repapering and client outreach; and setting up new curves and models for term rate calculation. In addition, ensuring the overall governance of the LIBOR transition through a dashboard after considering the large-scale impacts is of utmost importance.

Missing fallback clauses in agreements

A significant number of LIBOR contracts may not expire before December 31, 2021. Transitioning to an alternative benchmark rate is therefore imperative and will involve multiple actions on the contracts side before the migration:

- Identifying LIBOR contracts from the document repository
- Extracting LIBOR terms and clauses
- Establishing remediation categories
- Amending and repapering agreements
- Setting up client outreach processes to get the counterparties' signatures on the amended contracts

Identifying LIBOR contracts from the repository and manually extracting the meta-data or fallback clauses from the agreements will be a humongous task. The FCA directive requires banks to include 'pre-cessation' fallback triggers in addition to permanent fallback triggers. Given all these complexities, the prudent way forward for banks is to opt for a solution backed by artificial intelligence (AI) and machine learning (ML) that incorporates workflow capability to identify the IBOR contracts, extract the relevant terms and their metadata, classify key terms through pattern analysis and assign confidence scores to measure accuracy. Such a cognitive tool will enable firms to unlock exponential value by improving productivity, eliminating omissions, reducing misinterpretations, and mitigate risk.

Client outreach

Ensuring effective communication with clients and counterparties throughout the contract lifecycle will help banks reduce the disagreement risk. Client consent must be obtained once the contracts are amended or repapered. Deploying a unified customer relationship management (CRM) tool built using intelligent technologies will help identify the right documents from the repository. The tool would also enable pre-scripted email templates with clearly defined timelines and revert procedures. In addition, it will send automated emails with the appropriate attachments and enable automated review of negative and positive consents. The intelligent CRM tool will help personalize communications to the context of different agreement types, which in turn will significantly improve the customer experience and reduce the response time for banks to act on transitioning to the new RFR.

Overnight term rates

With the market waiting for the forward-looking term rate based on overnight rate to be established, it may be a good time to adopt the alternative to the backward-looking approach. This approach generally involves compounding the actual overnight rate over the length of the period. Backward-looking term rates will be useful for calculating interest payments at the end of the tenor. For effective hedging, the term rates for all the RFRs must be calculated using the forward-looking approach. This computation will require the use of complex formulae recommended by regulators and third party rate providers. The market is depending on the higher volumes of interest rate derivatives that is expected to start soon.

Governance dashboard

BFSI firms must consider building a highly interactive LIBOR governance dashboard to track program delivery and milestones and evaluate profit and loss impact and risks. The dashboard must also have the capability to monitor exposures, legacy transaction transitions, contract amendment and consents, as well as valuation difference between IBOR and RFR. A dashboard built using intelligent technologies will give a real-time graphical view of exposure and state of transition besides rendering the flexibility to slice the data according to specific parameters such as products, tenors, lines of business and maturity date. The dashboard must also encompass the ability to perform 'what-if' analyses for data-driven decision-making. This will yield crucial insights to the business users and facilitate effective decisions during the transition phase.

Take the Next Step

With the deadline for LIBOR decommission fast approaching, the subject of finding a suitable replacement is gaining traction. Clearly, banks need to act quickly to close their LIBOR positions and book trades using the new RFRs to avoid operational challenges, enable better risk management, avert financial instability and ensure regulatory compliance. LIBOR transition, though, will come with quite a few obstacles given banks' complex operational landscape. The next two years will be mission-critical to achieve the necessary scale to complete the transition with minimal disruption before end 2021. Banks should not leave it to the last minute but immediately begin investing in the necessary infrastructure change programs and set the ball rolling for a hassle-free migration. However, banks may be constrained by lack of domain expertise and technology knowledge to manage the transition in-house. To ensure a trouble-free and seamless transition, banks must consider partnering with a service provider with the right mix of domain and regulatory knowledge, digital accelerators, and software expertise. However, they should take care to choose the right partner after a well-rounded market analysis.

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