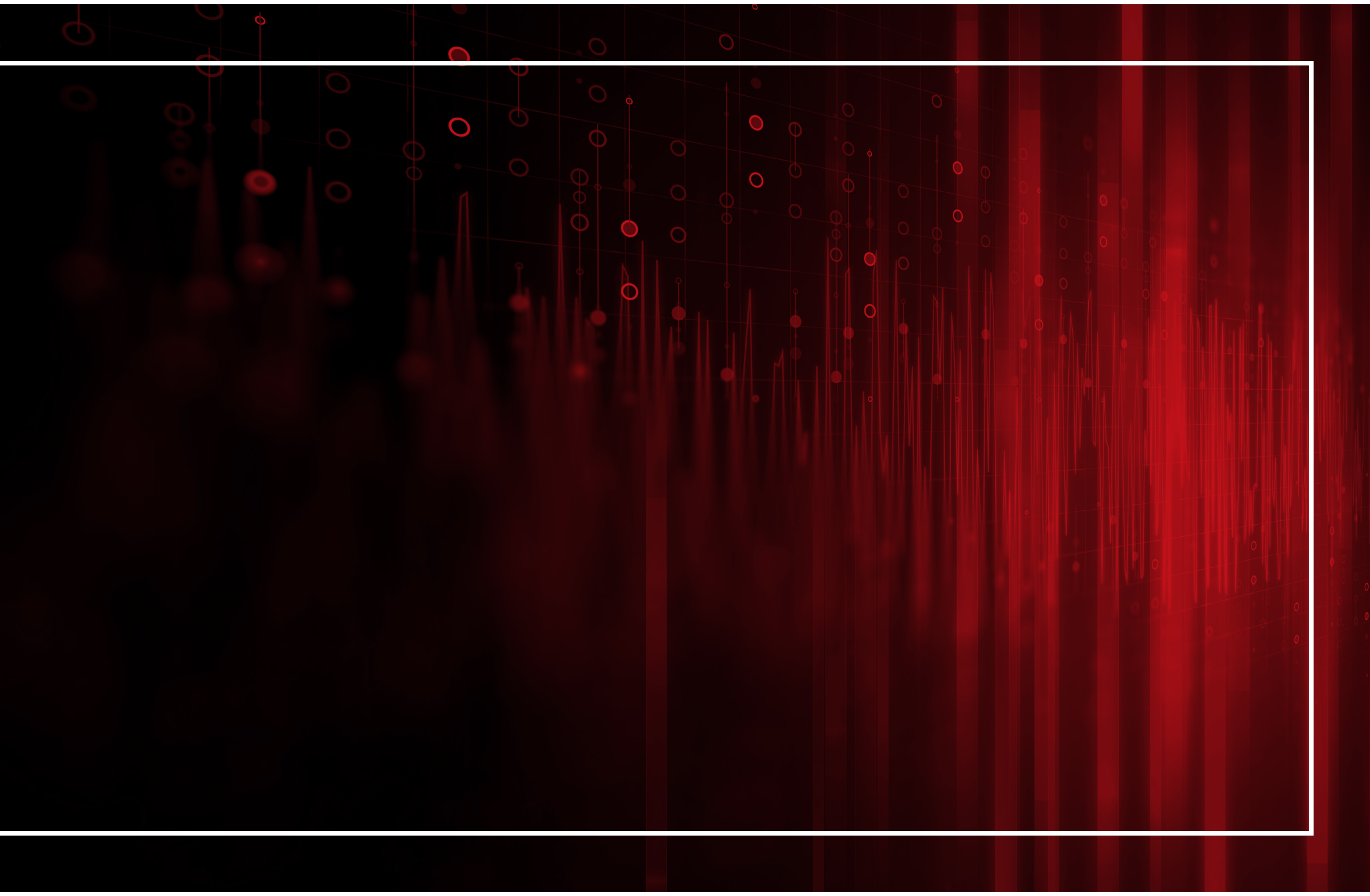
REPLACING LIBOR

A SWISS PERSPECTIVE ON THE TRANSITION FROM LIBOR TO NEW ALTERNATIVE RATES



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INTRODUCTION

The London Interbank Offered Rate (LIBOR) has been the bedrock for Swiss and global financial institutions for decades, serving as the primary benchmark for short-term interest rates. Over the years, LIBOR has acted as a reference figure for hundreds of trillions of dollars in derivatives, bonds, loans, securitizations and deposits.

In July 2017, the U.K.'s Financial Conduct Authority (FCA) Chief Executive Andrew Bailey announced that all twenty panel banks submitting to LIBOR had agreed to search for alternative rates and replace LIBOR by 2021.

The main factors driving this change are:

RATE MANIPULATION

LIBOR has been involved in multiple charges of attempted rate manipulation and false reporting by financial firms seeking to increase profits or mitigate losses. As early as 2008, it was determined that a vast number of financial institutions had manipulated rates to their advantage, while LIBOR continued to be used as a measure of the overall health of the financial system. Regulators in the U.S., U.K. and E.U. have fined banks more than USD 9 billion for rigging LIBOR.

MARKET LIQUIDITY CONCERNS

Following the financial crisis of 2008, it became apparent that IBORs (interbank offered rates) were potentially risky as benchmarks, lacking the overall volume of activity to safely support the unsecured lending market. Increased regulatory and capital requirements post-crisis have led to a move away from the relatively costly short-term lending on LIBOR. Over time, the number of transactions and daily volumes has decreased, resulting in concerns over sustainable liquidity.

The initiative to replace LIBOR will trigger changes for the five interest rates it is based on - USD, EUR, GBP, JPY and CHF. Several central banks have proposed alternative rates based on a large number of repo transactions, compared to LIBOR, which is based on expert discretion from a group of panel banks.

The Swiss National Working Group has selected SARON (Swiss Average Rate Overnight) as the preferred alternative benchmark rate to CHF LIBOR. The swap market began referencing SARON in 2017. Fully robust replacement rates are expected to be in place globally by the end of 2021.

ALTERNATIVE REFERENCE RATES PER CURRENCY

Currency	Alternative Reference Rate to LIBOR	Working Group	Characteristics of the Underlying Instrument
CHF	Swiss Average Rate Overnight – **SARON**	National Working Group on Swiss Franc Reference Rates	SECURED
$	Secured Overnight Financing Rate – **SOFR**	Alternative Reference Rates Committee	SECURED
£	Reformed Sterling Overnight Index Average – **SONIA**	Working Group on Sterling Risk-Free Rates	UNSECURED
€	Euro Short-Term Rate – **ESTER**	Working Group on Euro Risk-Free Rates	UNSECURED
¥	Tokyo Overnight Average Rate – **TONAR**	Study Group on Risk-Free References Rates	UNSECURED

Source: Working Groups, European Central Bank, ISDA

THE TIMELINE TO REPLACE LIBOR IS SHORT AND AMBITIOUS:

27TH JULY 2017

FCA announces that LIBOR is to be phased out by 2021

5TH OCTOBER 2017

SARON is recommended as the alternative to CHF LIBOR. The NWG establishes two sub-groups: the loan and deposit market sub-group and the derivatives and capital markets sub-group

18TH OCTOBER 2017

LCH, a leading clearing house, clears first swap referencing SARON

YEAR-END 2017

SARON replaces TOIS fixing in the swap market

4TH JUNE 2018

NWG publishes recommended contract specifications for SARON futures

JAN 2019

Transition phase from IBORs to alternatives begins

YEAR-END 2021

LIBOR submissions will be supported until year end. Alternative rates like SARON must be ready for full transition

CHALLENGES AND IMPACTS

FOR SWISS FINANCIAL INSTITUTIONS

The transition from LIBOR will affect many areas of every financial institution. The following section outlines the major areas of impact.

1. PRODUCT MANAGEMENT

With the introduction of new rates, institutions will need to identify existing product portfolios (by asset class) that are impacted by the transition away from LIBOR. While products based on alternative rates are in their infancy, it will be critical for institutions to have a firm grasp on the key differences between LIBOR and the new referencing rates product development and management.

2. BUSINESS RISKS

Transitioning from LIBOR to an alternative rate involves potential risks such as market-to-market impact, credit/margin requirements and other rate-related implications that could influence both capital markets and retail banking operations.

As institutions transition to overnight funding rates such as SARON, business operations will need to understand the fundamental changes triggered by the alternative benchmarks and their impact on various functions (e.g. treasury).

The transition approach should include all business units and entities within an organization. While traditionally siloed, capital markets should align with other business areas (e.g. retail banking, asset management and wealth management) as organizations prepare to develop and produce products based on alternative rates. Furthermore, as LIBOR rates potentially fall out of use and new products grow, banks should adjust research and risk models that are dependent on LIBOR.

3. CUSTOMER DISCOUNTING

Customer discounts based on alternative rates such as CHF SARON, will require institutions to consider not only the calculation differences between SARON and LIBOR, but also how these calculations will impact lending and discounting. Today's customers are more likely to resort to legal action if they believe they are misled. However, the average customer is not aware of the differences between LIBOR and new referencing rates and will not know which is a better deal. Investor protection regulations (i.e. MiFID II) require firms to inform customers about pricing components. Firms will need to deal with communication challenges regarding the change in discounting rates and manage client expectations accordingly.

4. MANAGING CONTRACTS AND RISK MANAGEMENT

In addition to business risks, institutions will face conduct, legal, operational and market risks when coordinating efforts on existing and new contracts (e.g. derivative, mortgage, loan, etc.). With potential pitfalls in transitioning away from LIBOR, institutions need to implement a centralized transition strategy which includes contract generation and ensures compliance. A coordinated client outreach is required to inform and repaper existing service and product agreements.

5. BUSINESS PROCESSES, IT AND INFRASTRUCTURE

Existing operational procedures, processes and involved applications will need to be reviewed accordingly. This includes amending hardcoded rates and reviewing respective IT releases. Technology enhancements, front to back transformation, infrastructure revision and adjustment of relevant support systems (trade capture, payments systems, and more) should also be considered. Solid data analytics will be necessary to minimize transition costs. Lastly, data sourcing and management should be examined, e.g. refresh of rates frequency, benchmarking data validation and reference data management.

HOW CAN CAPCO HELP

Considering the magnitude of products, securities and processes (IT, governance, legal & compliance) affected by the transition away from LIBOR, firms cannot afford to delay action on their changeover efforts.

Capco can support clients by first establishing a fit-for-purpose impact assessment, structured around key stakeholders. The next step is the analysis of specific products, event-triggered processes, and other unique attributes. A key to success would be to understand existing common denominators amongst functions, products and processes. While the expectation is that regulators will define the necessary requirements in the near future, it is advantageous for firms to be transparent with regulators about their transition plans from the early stages. Having a comprehensive overview of the transition impacts, however, is essential.

SCOPE OF FUNCTIONS TO ASSESS FOR TRANSITIONING FROM LIBOR

LINE OF BUSINESS

- Review of direct impacts to capital markets, retail and commercial businesses
- Assessment of impact on customer pricing and discounting
- Assessment of product management and offerings portfolio

OPERATIONS

- Review of customer contracts and existing agreements facing direct impact
- Adjustment of trade lifecycle functions and implementation capabilities for managing products based on new rates

BACK OFFICE

- Review of potential impacts to the front office supporting functions and processes (i.e. clearing)

LEGAL

- Contract development and operations review
- Evaluation of impact of replacing LIBOR rates with new rates
- Assessment of existing LIBOR-based contracts

TECHNOLOGY

- Assessment of existing applications supporting rates trading
- Analysis of imbedded systemic logic that provides market-to-market and other rate-related calculations

COMPLIANCE

- Review of existing controls and supporting procedures for LIBOR-related activities
- Review of customer pricing and discounting processes

Amidst the uncertainty around the transition from LIBOR, organizations can prepare and strengthen their positions by understanding how products and assets, client management and operational risks will be impacted as the transition progresses.

IMPACT ASSESSMENT CATEGORIES

1 PRODUCTS & ASSETS

Understand how business operations manage products currently and how future products and asset portfolios may change

- In coordination with the identified impacted business units, determine which existing products and asset class offerings will be impacted by the LIBOR transition
- Leverage existing playbooks for product development to determine how business units will approach a SARON-based product

2 CLIENT MANAGEMENT

Assess and communicate the direct impacts on discounting and supporting contracts

- Prioritize between examining (a) how new contracts will be established and operationalized, and (b) how existing LIBOR-based contracts will be managed
- Clarify with stakeholders the strategic approach to informing clients on how the transition from LIBOR will affect their assets (i.e. contracts, discounting, etc.)
- Gain collective insights from program stakeholders on potential risks (and their mitigation) when establishing discounting practices based on SARON

3 OPERATIONAL RISKS

Formalize the components of operations which can be both directly and indirectly impacted by transitioning from LIBOR

- Coordinate amongst the impacted functions to determine which key potential legal, compliance, and operational risks should be further explored
- Create a program structure to measure, assess and prioritize the risks identified

A thorough impact assessment, as a start, provides institutions with focus points for their particular areas of impact across products and asset management, client management and risk management. Key points of consideration, as depicted above, illustrate how firms will need to think both broadly and in-depth as the transition from LIBOR unfolds.

Although there is a chance that LIBOR could continue to play a role as a reference rate for financial instruments beyond 2021, institutions should not remain passive and aim to mitigate the multiple potential transition risks by acting now.

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