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BRIEFING NOTE:

TRANSITION TO RISK FREE RATE BENCHMARKS

A TREASURER'S CHECKLIST

FEBRUARY 2020 (2nd edition)

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Briefing note

TRANSITION TO RISK FREE RATE BENCHMARKS

A TREASURER'S CHECKLIST

The Association of Corporate Treasurers

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EXECUTIVE SUMMARY

In July 2017, Andrew Bailey, Chief Executive, Financial Conduct Authority (FCA), announced that banks would no longer be compelled to submit data to the LIBOR benchmark administrator after 2021 so effectively announcing the end of LIBOR.

In some respects, this should not have been a surprise as the G20 through the remit of the Financial Stability Board (FSB) recommended as far back as 2014 that market participants should move away from IBORs and consider using near risk free rates (RFRs) instead.

Taking a currency by currency approach, the various central banks whose currency is impacted by a transition away from IBORs (e.g. USD LIBOR, JPY LIBOR, TIBOR) have identified alternative rates for their markets to transition to and the 'LIBOR transition' project is now moving into the implementation stage.

After a slow start, transition is generally picking up pace with new products being made available in more markets and transactions referencing the replacement RFRs being transacted. The FCA have announced in the UK that they do not expect any loans referencing LIBOR to be written after the end of September 2020. This will be a major challenge – see Appendix B for detail.

As is often the way with developments in the financial markets, many things are outside of the treasurer's control. Nevertheless, non-financial corporates need to:

- Understand what the transition away from LIBOR means for both treasury activities and the wider organisation (LIBOR is pervasive in many corporates), and
- Identify the steps needed to ensure a smooth transition for their organisation

The objective of this Briefing Note is to provide a starting point for corporates who currently use a LIBOR as a reference rate and need to be prepared to move to alternate (RFR) benchmarks ahead of the 2021 deadline.

It is structured as a checklist to assist corporate treasurers as they develop project plans for managing the transition. This Briefing Note is not a detailed description of the latest developments in the various markets impacted by LIBOR transition, as this is evolving very rapidly now.

The ACT LIBOR web page at: **treasurers.org/liborreform** provides additional background information and is regularly updated with the latest developments including any newsletters or other communications from the various working groups and the regulators.

This Briefing Note has been drafted with extensive input from the members of the RFR Corporate Forum.

A HISTORY OF LIBOR

LIBOR evolved in the 1960's in response to demand for syndicated loans that enabled companies and countries to borrow large sums from consortia of banks who funded the loans through a series of short term deposits.

The interest rate for these loans was set by a group of "reference banks" within each syndicate who would report their funding costs based on interbank lending costs shortly before a loan rollover date. The weighted average of these submissions, rounded to the nearest 1/8th percent plus a 'spread' for profit, became the price of the loan for the next period and was referred to as the London Interbank Offer Rate (LIBOR).

The use of LIBOR expanded into derivatives markets, initially to hedge the loan market but then evolving to become the much larger market that it is today. (It is estimated that around 80% of all contracts that reference LIBOR are derivatives and that the total market has a nominal value of over USD 400 trillion globally).

LIBOR is currently quoted for five different currencies (USD, EUR, GBP, JPY and CHF) and across a number of tenors (predominantly 1, 3, 6 and 12 months).

Changes in the underlying funding models for banks significantly reduced liquidity in the interbank lending market and exacerbated vulnerabilities in the calculation of LIBOR which facilitated the manipulation of the benchmark rate which came to light around 2012.

This has ultimately resulted in the reform of LIBOR and the additional recommendation by the FSB to move to the use of risk free rates.

LIBOR AS A BENCHMARK RATE FOR CORPORATES

Expanded from the original use in the syndicated loan market, LIBOR is used extensively by corporates. A comprehensive list of uses of LIBOR is included in Appendix A, but the principal product areas where LIBOR is used by corporates include:

- the syndicated loan market
- FRN (bond) market
- derivatives market

In addition, LIBOR is used as the reference rate in a variety of commercial scenarios including:

- Late payment clauses
- Cost increases in long dated contracts
- Bank guarantees

LIBOR is also widely used as the reference rate for inter company (intra-group) lending arrangements.

Given that there is no guarantee that LIBOR will continue to be published after 2021, corporates must start to prepare to transition away from LIBOR as soon as possible to minimise the longer-term risks of referencing a 'dead' benchmark.

TRANSITION TO RFRS – CHECKLIST FOR CORPORATES:

THE KEY STEPS A CORPORATE TREASURER SHOULD ACTION:

A. Do your research
B. Hold discussions with counterparties
C. Make a plan
D. Implement the plan

A. DO YOUR RESEARCH: IDENTIFY THE SCALE OF THE CHALLENGE FOR YOUR ORGANISATION

1. THE FINANCIAL MARKETS

Understand the latest developments in LIBOR transition

After what appeared to be a slow start, the transition project is picking up speed as the 2021 deadline comes into focus.

The benchmarks being developed to replace LIBOR have very different characteristics to LIBOR which will impact how they can be used to manage risk for corporates.

Furthermore, each LIBOR currency is working in a certain degree of isolation. As a result, each is developing a slightly different solution, to differing timescales. This lack of consistency is throwing up challenges particularly when it comes to identifying market conventions.

Financial Market Solutions: The financial markets are consulting on, and developing, new derivatives and other products based on the alternate RFR benchmarks. However different products (e.g. loans, derivatives) have different characteristics and risks so treasurers should talk to banking partners and information providers to understand how the market is evolving.

Considerations for each currency LIBOR relevant to your organisation:

i. How does the relevant RFR market function, price etc. For example, in the UK how does SONIA 'work', what is the OIS (overnight index swap) market – is it relevant?

ii. How will the replacement RFR benchmark be calculated?

iii. Different currencies may come up with different market practices – what does this mean in practice for the organisation?

Consider alternatives other than replacing existing references to LIBOR with a reference to an RFR benchmark, particularly for commercial or internal agreements or those where the exposure is minimal. This may include moving from term rates to overnight rates or to a fixed rate; referencing treasury/gilt yields instead of benchmark rates; asking financial counterparties for innovative solutions.

2. THE ORGANISATION

Undertake an audit

Review activities within the organisation to identify all products, systems, contracts etc. where LIBOR (in any currency) is currently used as a reference rate. (See Appendix A for a non-exhaustive list of areas where LIBOR is typically referenced as a starting point).

Considerations:

i. Review legal documentation to identify which contracts may need to be re-negotiated in the event of LIBOR no longer being available.
   - This may include commercial contracts not exclusively treasury contracts.

ii. Identify any internal and external counterparties that may be impacted – this is not only banks.

iii. Identify processes that need changing (e.g. charging of interest on overdue receipts).

iv. Understand the impact of any change on accounting and valuations.

v. Talk to tax (including any transfer pricing team), controllers, procurement, credit and any JVs that have their own financing (such as project finance arrangements).

Read through Appendix B of this document – Key Issues for Corporates – and note those areas that may be particularly relevant for your organisation.

B. HOLD DISCUSSIONS WITH COUNTERPARTIES

Talk to relationship banks, lawyers, auditors, credit rating agencies, debt holders, systems providers, data providers, shared service centres to understand:

i. Their position/understanding of the possible impact of LIBOR transition on the activities you undertake with them.

ii. Their solutions (or thoughts) about how transition might be worked through.

N.B. Infrastructure providers (e.g. TMS providers) will be key to enabling corporates to implement new ways of working.

C. MAKE A PLAN

Using the classic approach to risk management (identify, assess, manage, report), having identified the relevant issues, decide how (or indeed whether) to address them.

1. LEGACY CONTRACTS

Legacy contracts are those that do not mature until after the end of 2021. Depending on the financial product under consideration (loan, derivative etc), the precise response to the disappearance of LIBOR will vary.

Much existing fallback language in financial contracts (language which is in place to ensure that the contract can continue in the event of a benchmark being unavailable) does not assume a permanent discontinuation of a benchmark, and therefore some contracts may revert to a fixed rate unless amended.

Considerations:

i. Do you want to amend the fallback language in your contracts?

ii. If so, how do you amend existing fallback language?

- ISDA is working to develop fallback language that can be retro-fitted to derivative contracts as such contracts are largely standardised. This will be done through the publication of an ISDA protocol (methodology which applies 'new' terms to all existing contracts if accepted by both counterparties)
- The situation for cash products is more complex as contracts are not standardised and therefore may need to be renegotiated on a case by case basis. Corporates should consider what would be 'acceptable' to them.

iii. If renegotiation of a contract is required will majority or 100% approval be required?

iv. How long is any renegotiation likely to take?

v. Transfer of value arising from renegotiation should be monitored/avoided.

There may also be intra-group contracts that will need revision to match any external transactions

vi. There may be taxation implications (transfer pricing) that should be worked through with the tax authorities in advance of transitioning intra group loans away from LIBOR

N.B. you may decide not to amend fallback language on derivatives (e.g. using the ISDA protocol) if an identical replacement fallback cannot be put in place on the underlying cash product.

2. NEW TRANSACTIONS

As soon as is reasonably possible (i.e., once there are products available), corporates should start to look at using financial instruments that reference the replacement benchmarks. This is for two main reasons:

- It mitigates the risk of issuing a product referencing a benchmark that is expected to disappear (N.B. This is a risk factor that needs to be disclosed on all new issuance here forward), and
- It minimises the tail of legacy transactions (which may be complicated to resolve).

Considerations:

i. Is it appropriate to include fallback language to enable transition to a replacement benchmark if necessary? This might be a fallback from LIBOR to an RFR, or in future from an RFR to another benchmark.

- There is a genuine possibility that financial markets will evolve over the next few years with the result that corporates will want to transition to another alternate benchmark as the new financial products and markets become established.
- In addition to the work by ISDA, the LMA is developing fall back language for loans.

ii. Be wary of complex structures/solutions – particularly for smaller, less sophisticated organisations.

iii. It may be possible (or necessary) to postpone new transactions until counterparties have systems and processes available to reference the replacement benchmarks. This may need a detailed analysis of cost and risk (for example: is it better to renegotiate a loan now with a two-year maturity, or wait and extend to five years when the legal language becomes clearer and market conventions have been established.)

D. IMPLEMENT THE PLAN

Having made a plan, implementation may be time consuming and complicated. There will be many moving parts to this transition project.

Timelines: Any transition away from LIBOR is likely to occur over an extended period.

Considerations:

i. Are there periods when systems cannot be updated (e.g. due to SOX controls, year end close)?

ii. Are there times when certain external meetings cannot be held (e.g. in 'closed' periods)?

iii. How long it is likely to take to renegotiate documentation? (once you know what it needs to say) – or if indeed it is possible to amend existing contracts.

iv. To what extent does the Board need to be informed/involved in the decision making process? (scheduling transition around Board meeting dates will add additional complexity).

Resource: In many organisations LIBOR is pervasive and resource constraints – both internal and external – are likely to be a major factor in how quickly any transition can take place once replacement products have been identified.

Considerations:

i. Transition away from LIBOR as a benchmark reference rate is a project that reaches far beyond the treasury team and, as such, resource may be required from other parts of the organisation. Legal, tax, accounting, IT, procurement, pensions, shared services and other functions may need to be heavily involved.

ii. 'Expert' resource e.g. lawyers and systems providers) will become constrained as the end date approaches – there is a tightrope to be walked balancing availability of solutions and the resource to implement them.

Cost: There will be costs involved in the transition.

Whilst there may or may not be a transfer of value as legacy contracts are transitioned from LIBOR to RFR, there will be costs associated with the transition project itself. When setting budgets, it would be prudent to include the latter and to be able to explain this to the Board and investor community if necessary.

APPENDIX A

EXAMPLE USES OF LIBOR BY CORPORATES

This table (from an ISDA report) sets out the span of impact that benchmark transition will have and summarises which benchmarks and products are impacted:

Financial Benchmarks and Products that are impacted

Transition Scope

Benchmark by currency[1]	Product	Product examples	Market participants	
• GBP LIBOR • USD LIBOR • EURO LIBOR, EURIBOR • CHF LIBOR • JPY LIBOR, JPY TIBOR, EUROYEN TIBOR	• Over-the-counter (OTC) derivatives	• Interest rate swaps, forward rate agreements (FRAs), cross-currency swaps	• Central counterparties (CCPs) • Exchanges • Government-sponsored enterprise (GSE) • Investment banks • Commercial banks • Retail banks • Asset managers	• Pension funds • Hedge funds • Regulated funds • Insurance/ Reinsurance • Corporations • Non-bank lenders • Supranationals • Others
	• Exchange-traded derivatives (ETDs)	• Interest rate options, interest rate futures		
	• Loans	• Syndicated loans, business loans, mortgages, credit cards, auto loans, consumer loans, student loans		
	• Bonds and floating rate notes (FRNs)	• Corporate and non-US government bonds, agency notes, leases, trade finance, FRNs, covered bonds, capital securities, perpetuals		
	• Short-term instruments	• Repos, reverse repos, time deposits, credit default swaps (CDs), commercial paper		
	• Securitised products	• Mortgage-backed securities (MBS), asset-backed securities (ABS), commercial mortage-backed securities (CMBS), collateralised loan obligation (CLO), collateralised mortage obligation (CMO		
	• Other	• Late payments, discount rates, overdraft		

[1] **Regulatory reform initiatives, including the selection of alternative RFRs, are underway with respect to other IBORs that are not in scope for this review. The in-scope IBORs are those in which an RFR Working Group is currently operative or being established. For further information on the progress pertaining to other IBORs, market participants should consult with relevant trade association representatives.**

1) Treasury Activity – Debt finance and derivatives

LIBOR may be used to price:

- inter-affiliate/intra-group loans and current accounts (including transfer pricing documentation)
- bilateral and syndicated loans (including project finance)
- letters of credit
- private placements (US and EU)
- securitisations
- floating rate notes

LIBOR is used in many interest rate derivatives (forwards, swaps, options) and cross currency swaps:

- to determine payment obligations
- for pricing purposes (including for the purposes of providing a quote)

LIBOR is also used in other types of corporate-facing derivatives transactions:

- hedging against risks in the business or against risks in a particular transaction (e.g. securitisation or a structured finance transaction)
- in the context of a corporate's portfolio management (e.g. managing rates of return on investment/assets against an entity's liabilities).

LIBOR is also used by corporates when lending money to third parties:

- Trade finance arrangements (e.g. invoice discounting)
- Financing franchisees
- Structured finance arrangements

2) Commercial contracts

LIBOR may be used as a reference rate applicable to payment obligations in some commercial contracts, e.g.

- Late payment clauses in commercial contracts
- Gross up provisions/price adjustment mechanisms in share/business purchase agreements (where payment is made after completion date)
- It might also be used e.g. to define an investment return hurdle in some contexts

3) Accounting and reporting disclosures in financial statements

LIBOR is used to account for many interest rate derivatives (forwards, swaps, options) and cross currency swaps:

- To calculate the fair value for accounting for each derivative
- To determine hedge effectiveness if hedge accounting
- To calculate and report financial disclosures required by GAAP in the financial statements e.g. IFRS 9

4) Industry Specific Uses

LIBOR may be specified in some industry guidelines. For example, for insurers, the EOIPA risk free rates used to calculate pension liabilities currently rely on the LIBOR swap curve and any change will impact on insurers' capital positions.

5) Internal Reporting

LIBOR may be used as a benchmark for internal reporting or analysis. For example, for measuring marginal investment returns or in economic appraisal of projects with embedded financing arrangements.

6) Other areas

There may be an impact on company pension funds, captive insurance companies.

Financial Stability Board – extract from report[2]

Market Participants Group on Reforming Interest Rate Benchmarks

Cross Currency Summary
Impact of benchmark Reform on Corporates

Table 11: Uses of IBOR by Corporate Survey Respondents (non-comprehensive)

Uses of IBOR	• Pricing of inter-affiliate/intra-group loans • Hedging of discount rates and/or inflation in respect of defined benefit pension liabilities or other post-employment liabilities • Swapping a debt obligation in one currency to another currency using a cross-currency swap that involves an IBOR • Discount rates for valuation purposes • Performance benchmarks for money market funds and/or other asset managers • Standard interest rates for pricing long-term commercial contracts • Late payment clauses in commercial contracts • Long-term project finance contracts/joint ventures • Trade Financing Solutions (e.g. factoring or supply chain financing by highly-rated corporates that provide financing for their suppliers with less direct access to credit) • Hedging the variable interest rate on a floating rate debt obligation by "swapping" to a fixed rate using an interest rate derivative (could also be "swapping" a fixed-rate to a floating rate using an interest rate derivative)
Loans/Credit Facilities	• Asset securitisation pricing • Pricing on secured and unsecured debt issuance which may be directly linked to IB0R • Primary syndicated loan agreement that is IB0R based • Pricing of corporate borrowing drawdown and credit lines/facilities • Revolving Credit Facility pricing that is based on IBOR • Interest appointment between members of a cross-border, cross-currency cash pool
Accounting Purposes	• Accounting – IBOR may be used in fair value calculations for discounting provisions,impairments and financial leases. It may also affect (indirectly) capitalisation of interest for project accounting
Regulatory Cost of Capital	• As part of the discount rate for property valuation calculations – used in bank lenders' loan security covenant testing and valuation • Indirectly used in setting regulatory cost of capital using a CAPM model with cost of debt components
Commercial Contract Clauses	• Asset transaction Sale & Purchase agreements will occasionally make use of LIBOR benchmarks in the definition of price adjustment mechanisms where the settlement date differs from the effective date of the deal. The buyer would typically agree to pay LIBOR plus a spread during this period • Price escalation clauses in long-term supply/purchase contracts
Pricing/ Valuation of Financial Instruments	• Used in pricing some trade products, such as contracts for difference (CFOs) • Rate is used in some types of option pricing • Pricing of floaters

[2] "Market Participants Group on Reforming Interest Rate Benchmarks Final Report," March 2014, http://www.fsb.org/wp-content/uploads/r_140722b.pdf

APPENDIX B

THE PRACTICAL IMPLICATIONS OF BENCHMARK REPLACEMENT FOR CORPORATES

Working Note January 2020

This appendix may quickly become dated. However, it has been included to flag the issues that corporates in particular need to understand and ensure that they have been resolved to their satisfaction. It cannot be a complete list of all issues but is offered to provide thinking/discussion points.

(NB – a satisfactory resolution for one corporate may not be applicable for others, dependent on risk appetite, levels of sophistication of financing, business complexity and approach to hedge accounting etc).

A. CURRENT STATUS

The FCA has announced that it no longer wants LIBOR referencing cash products that mature after the end of 2021 to be issued after the end of Q3 2020 (i.e. September this year).

Irrespective of whether one considers new or legacy transactions, there are a number of challenges that need to be addressed to enable corporates to transition successfully to replacement benchmarks:

a) **Market Conventions – to enable corporates to transact against the market standard**

Market conventions are still in development and covering topics such as (but not limited to) day count conventions (treatment of non-working days), calculation of a term SONIA (number of significant figures; whether there should be a lag or lock out on the interest period, and if so, what period this should be).

b) **Consistent Calculation methodologies – the need for a 'free to use' calculator to enable 'one version of the truth'**

There are currently a number of calculators available but little consistency between them. In order for corporates to get comfort that they are using the 'correct' numbers, there should be a 'gold standard' free to use calculator. There are growing calls for the provision of an index which would simplify the calculation of a backward-looking rate.

c) **Infrastructure – bank and corporate**

The administration of a daily fluctuating, backward-looking rate is not currently supported by loan product systems used by most lenders (or borrowers). Infrastructure providers are being encouraged to address this, as systems will be a pre-requisite for many counterparties to be able to transact.

d) **Documentation**

Both ISDA (for derivatives) and the LMA (for loans) are developing revised standard agreements to be used in the case of RFR referencing transactions. In the case of loans in particular, there are still a number of 'unknowns' that are negotiation points – a number of which relate to outstanding uncertainty around market conventions.

e) Lack of product for corporates to analyse/adopt

Slow market evolution to date has resulted in a lack of clarity for corporates and meant that, to date, there is relatively little corporates can do to actively transition away from LIBOR referenced instruments.

(NB – many corporates will need additional lead times to receive Board mandate to transact the new products).

B. FINANCIAL MARKETS CONSIDERATIONS FOR LEGACY TRANSACTIONS

Legacy transactions are those transactions that currently refence LIBOR and will mature after the end of 2021.

Legacy Transactions can be broken down into a number of categories:

a) Legacy transactions that can be actively transitioned away from LIBOR

b) Legacy transactions that can't be transitioned away from LIBOR – 'tough legacy'

c) Legacy transactions that will 'fall back' to alternate rates on LIBOR discontinuation – largely as a result of existing language in the contract or as a result of the adoption of a mechanism such as an ISDA protocol.

a) Active Transition

In the UK, the FCA are encouraging active transition.

In addition to the issues identified under 'Current Stats' above, there may be practical difficulties with obtaining the necessary consent to any amendments. For example, the syndicated loan market does not have a protocol system for amendments (such as that operated by ISDA) and therefore each individual loan agreement referencing LIBOR would need to be renegotiated to refer to an alternative benchmark rate unless an alternate solution is identified.

Parties may also use this as an opportunity to renegotiate terms unrelated to LIBOR (this was seen when certain tenors and currencies for LIBOR were discontinued), which would add further time and complication to any amendment process.

Economic discrepancy between LIBOR and any alternative benchmark will require discussion on alternative pricing to reflect the change in economics.

b) 'Tough' legacy

This category includes transactions such as those with no fall-back provisions

During H1 2020, the market and the official sector in the UK are working through how these types of contracts may be addressed. It is expected that something similar will happen in other jurisdictions.

c) Fall-Back Arrangements

Whilst fallbacks are frequently included in existing documentation should a benchmark become (temporarily) unavailable, generally these were not drafted in the expectation of permanent discontinuation.

For example, the ultimate fallback in loan agreements is generally to an individual lender's cost of funds and floating rate notes ultimately fall back to a fixed rate, neither of which are likely to be acceptable to either counterparty in the longer term.

The principle concern amongst corporates is how one moves a forward-looking rate with a credit and term elements to an overnight rate with a commensurate credit spread. Although there have been solutions in development in the derivatives market, there is a need to educate the wider market (e.g. how any credit spread adjustment will be calculated and applied) and also translate any solution into the cash markets.

The precise mechanism for this remains unclear and is moving at different speeds both between jurisdictions and across products.

C. IN HOUSE CONSIDERATIONS FOR CORPORATES

a) Awareness raising

Although there is greater awareness of the transition away from LIBOR to alternate Risk-Free Rates, there remains a fundamental lack of understanding about what benchmark transition means in practice for most organisations.

Corporates generally take the role of market takers (effectively clients) in the financial markets and as a result are largely dependent on their counterparties or other advisers (predominantly banks) to explain to them how the products being developed to replace LIBOR based products will work.

There are some specific areas where awareness is key:

i) The Board

- May need to approve the use of replacement benchmarks and will need to understand the implications so they can explain to investors and other stakeholders

ii) The business

- Lack of cash flow visibility arising from a backward-looking rate may impact strategic decision making (e.g. investment decisions)
- Costs of transition will reduce funding available for business development

iii) Investors

- The cost of transition as well as the ongoing impact on business strategy will need to be explained

iv) Other stakeholders – e.g. pensioners whose returns may be calculated differently.

b) Cost

In theory, no counterparty should feel that they are at an economic disadvantage as a result of transition to a new benchmark rate.

However, costs likely to be incurred include:

i) Systems developments

ii) Legal fees – redocumentation expense; potential litigation expense

iii) Project costs to undertake audit

iv) Resource allocated to this project results in other projects not happening etc.

v) Potential transfer of value as contracts are migrated from LIBOR to RFR

c) Redocumentation of non-financial contracts

Customers and suppliers may need to be consulted about the approach to be taken with non-financial contracts (e.g. where LIBOR is referenced in late payment or payment increase clauses) – corporates will need to take a view on whether or not to renegotiate all of their commercial contract that are impacted.

d) Tax, Accounting and Regulatory Impacts

i) **Tax considerations –** particularly relating to arm's length pricing and inter-company lending.

Progress: Tax authorities are beginning to issue guidance on the approach that they will adopt in response to benchmark replacement. To date, this is piecemeal and not immediately apparent whether a consistent approach is being adopted.

ii) **Accounting considerations –** e.g. Loss of hedge effectiveness under IFRS or GAAP if existing contracts lose their hedge designation by being 're-papered'. This may have an impact on P&L and ultimately share values.

Progress: Accounting authorities (particularly IASB and FASB) are beginning to issue guidance on the approach that they will adopt in response to benchmark replacement. To date, it appears that accounting regulators are working to ensure that the transition does not negatively impact hedge accounting designations, but further guidance is expected H1 2020.

iii) **Regulatory implications –** e.g. Will re-papering trigger additional EMIR reporting requirements (variation margin for example)?[1]

Progress: the official sector is now aware of this risk and have issued positioning statements indicating that they expect national authorities to exercise forbearance (i.e. it appears that they are keen to avoid inadvertent triggering of regulatory application arising purely as a result of transition. However, this is still work in process).

D. OTHER GENERAL CONSIDERATIONS

a) A consistent international approach.

Although authorities are working 'by currency', this is not how organisations operate in practice; global coordination and consistency will be key for the successful transition (and importantly, to avoid any particular currency/market being put at a competitive disadvantage).

Specific challenges include:

i) **Consistency –** If the LIBOR replacement benchmark develops differently in different jurisdictions, arbitrage opportunities and competitive advantage may arise between markets. Inconsistency in the choice of RFRs across jurisdictions, particularly whether the RFR is secured or unsecured, may cause issues that will need to be resolved.

For example, in the loan market, drawings on a multicurrency loan or facility in different LIBOR currencies are currently priced at the same margin.

[1] The FSB October 2017 Progress Report on interest rate benchmark reform noted this potential concern and highlighted that it may be possible for national authorities to exercise forbearance in this area.

ii) **Comparability of benchmark rates –** Multinationals typically borrow in local currency so will need to consider how to compare between different benchmarks (potentially one based on unsecured and another based on collateralised transactions) when deciding which currency to raise and/or swap their funding into.

iii) **Operational challenges –** For example, benchmark publication times could vary across currencies causing significant complication (both operational and IT infrastructure).

There is a risk that if currencies do not remain aligned, borrowers will migrate to the 'easiest' currency to fund themselves – operational considerations being a factor in 'lowest cost of funds'.

Progress: the various bodies working on benchmark transition have started to coordinate their activities,

b) The impact of market disruption in the event of an unclear conversion path

If LIBOR continues to be published post 2021, the implications may include:

i) Fallback language will not be triggered

ii) Basis risk (between transactions priced off SONIA and those priced off LIBOR) will have to be managed

iii) There is also a conflict in that:

- If LIBOR continues to be published post 2021 one could put SONIA/LIBOR basis swaps in place for legacy contracts, but
- If LIBOR continues to be published post 2021 (in any form), existing contracts will not be obliged to move over to SONIA as there won't be a fallback trigger

Progress: the regulators across the world are alive to this risk and are exerting pressure to ensure a smooth transition. (This is a systemic risk for financial markets as a whole, although may feel more marginal to a corporate).

c) The need for a forward-looking (term) rate

It has been identified that certain clients (e.g. unsophisticated SMEs) and financial instruments will require a forward-looking rate (e.g. trade products that require a forward rate to calculate the discounted value of the assets).

Progress: some jurisdictions (e.g. the UK) have recognised the need for a forward-looking rate and are developing a solution. Others have, to date, announced that they will not be developing a forward rate (e.g. Switzerland).

d) Risk of Frustration

Uncertainty about which benchmarks to use and mandatory re-designation resulting in a real transfer of value may result in increased legal activity. For example, where one counterparty sues for frustration of contract. A 1bp change on a multi-billion-pound contract can have a material impact.

THE ACT WELCOMES COMMENTS ON THIS REPORT

Please send your comments to
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