TREASURY TRENDS

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Get ready for the global IBOR transition

Have you met SONIA?

In December last year, Commonwealth Bank of Australia ("CBA") did something that no other Australian bank had done before. It issued an Australian-origin transaction with a reference rate that was not an interbank offered rate ("IBOR"). The CBA transaction (GBP125 million of one year notes) referenced a margin of 40 basis points over the Sterling Overnight Index Average ("SONIA"), the interest rate benchmark being primed to take over from the London Inter-bank Offered Rate ("LIBOR").

The CBA deal is a visible sign that institutions are beginning to plan for the transition away from the traditional IBORs, a change described as one of the biggest to ever occur to financial markets. The transition will impact entities that are party to loans, deposits, bonds, debt instruments, and derivatives that currently reference an IBOR and will have wide ranging implications across risk management, financial reporting and back office processes.

Time for change

IBORs have been a bedrock of the financial markets for over 30 years but have been undermined in recent times by instances of fraudulent submissions (laid bare by various LIBOR rigging scandals in which some of the world's biggest banks have been caught influencing the daily rate set to their benefit). Also, the underlying markets are no longer being sufficiently active for accurate price discovery to occur.

With the UK's Financial Conduct Authority indicating that it will no longer require banks to submit daily LIBOR rates after 31 December 2021, there is a general assumption that all the IBORs will cease to exist on or before that date. In a somewhat uncoordinated fashion, regulators have therefore been pushing for viable replacement rates, with alternatives for the five main IBOR rates already progressing:

- SOFR is the replacement for US dollar LIBOR
- SONIA is the replacement for pound LIBOR
- SARON is the replacement of Swiss franc LIBOR
- TONA is the replacement for yen LIBOR
- ESTER is the replacement for euro LIBOR ("Euribor").

Key points

- **The global reforms to strengthen interest rate benchmarks mean key global reference rates including LIBOR are likely to expire by the end of 2021.**
- **Most major global markets have already proposed substitute benchmarks, although transition to date has been slow.**
- **The changes represent a huge challenge for financial markets and have far reaching implications for corporate risk management, financial reporting and back office processes.**

These alternative risk free reference rates are based on overnight funding markets (so there are plenty of transactions to calculate robust benchmarks) but use varying methodologies and are themselves in a developmental stage. The first four have been in existence, with daily reported values, since early 2018, and ESTER will begin to be reported sometime in 2019.

Of the various jurisdictions, the UK market is seen as the most advanced in transitioning. Although these overnight risk free reference rates may well be a starting point for alternative IBOR benchmark rates, they do not currently address the forward looking element for specified terms (existing IBOR maturities are typically offered in overnight, one week, and 1, 2, 3, 6 and 12 months tenors).

Importantly, the new reference rates will be based on liquid underlying market transactions, rather than submissions based on expert judgement, although all are significantly different in nature to the existing IBORs.

All of these new reference rates remain at an early stage of market contemplation and the extent to which these overnight rates could be used as a basis for the construction of a forward yield curve has yet to be proven. What is certain is that these new reference rates have very large shoes to fill, with the various existing IBOR rates thought to underpin some USD350 trillion of securities globally.

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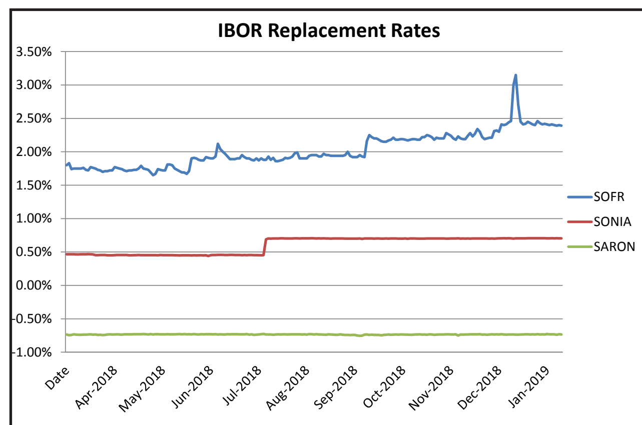
While the various regulators, and industry bodies such as the International Accounting Standard Board ("IASB") and the International Swaps and Derivatives Association ("ISDA") have been progressing transition arrangements, many uncertainties remain.



A local perspective

Australia and New Zealand have their own well-embedded and widely referenced benchmark rates (BBSW and BKBM respectively), both of which have undergone a number of improvements in recent years to strengthen the robustness and reliability of the daily calculations. Both are based on actual trade activity, recorded throughout a daily rate set window, and remain widely referenced in contracts for derivatives, loans and securities.

These credit-based benchmarks are likely to be with us for some time yet, although the global shift towards risk free reference rates could prompt some migration towards alternative benchmarks in some instances, with the cash rate for example, already referenced extensively as a financial benchmark. Regardless, the IBOR transition remains of critical importance in this part of the world, not only to any corporates operating overseas but also to banks raising funds and investors buying bonds in these markets.

Preparing for transition

Financial institutions are already beginning to issue risk free reference rate linked products to further deepen liquidity in the new reference rates. In the near term, it is likely that the vast majority of transactions will continue to be based on the various IBORs until there is widespread market acceptance of the alternative future reference rates.

Some flexibility and contingency measures are already starting to be incorporated into new documentation, to allow for subsequent amendments to interest rate determinations that may be required in the future. Fall-back language is currently seen as the primary mechanism for transition but, given the long tail of products with a post 2021 maturity, revising documentation on legacy transactions will be one of the thorniest challenges. There is clearly a huge amount of work needed to transition contracts to alternative reference rates and to update internal systems.

Banks have been working behind the scenes to ready for change in derivatives, back office and documentation, as well as existing deal transition. Corporates should also be assessing and disclosing any exposures and formulate strategies to prepare for life after IBOR.

With these financial benchmarks critical to the functioning of global financial markets, their replacements promise to have a major impact on financial products being offered. Additionally, they will impact the risk management approaches adopted by financial institutions and corporate treasuries, and also the associated valuation methodologies and accounting treatment. Firms need to plan for the change to be ready in 2021.

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