Webinar: Operationalizing the Transition

The transition away from the London Inter-bank Offered Rate (LIBOR) will impact many layers within a firm's infrastructure, most notably its operations.

IHS Markit recorded a series of webinars to help firms navigate the final steps of the LIBOR transition. In our first recording, **Operationalizing the Transition**, IHS Markit experts and industry leaders from partner firms addressed questions related to the 18-month US-dollar-LIBOR extension and new fallback rights. The panel also gave tips on how to be proactive in preparing for the transition and offered key tactics firms can take this year.

Here is a sample of what we covered in the webinar. Click here to download the full recording.

Q: What are the details of the US-dollar-LIBOR extension?

A: There's been an 18-month extension of US-dollar LIBOR to 30 June, 2023. But, it's not a blanket extension; there are limitations, which stand to impact markets and firm strategies.

The extension was based on the idea that legacy products have more time to transition naturally, their risks mitigated without the use of specific fallback language. But, in making the extension agreement with financial institutions, ICE Benchmark Administration, the Financial Conduct Authority (FCA), the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of Currency (OCC) and other regulatory authorities were clear that they would restrict new US-dollar trading, bidding or lending from 1 January, 2022. This provides a platform for increased liquidity in the Secured Overnight Financial Rate (SOFR) prior to the official end of US-dollar LIBOR.

There has been talk of potential market fragmentation post-2021, with some firms questioning the impact this may have on their transition plans. To reiterate, US and UK regulators have spelled out that there should be no new US-dollar-LIBOR transactions after the end of this year, except in limited cases. This is expected to significantly decrease liquidity in instruments indexed to US-dollar LIBOR. As a result, there will likely be an increased cost to hedge and increased bid-offer spreads. Even with an 18-month extension, some transactions may be difficult to mitigate and could need state or federal legislative support.

Should different dates have been considered or other safety nets put in place for certain legacy contracts? Hear more when you listen to the complete webinar recording.

Q: The transition includes eased protocols and fallback rates for contracts that will not be able to shift by the end of 2021 or the end of US-dollar LIBOR. When will fallback rates be triggered and what will be the operational impact?

A: The ICE Benchmark Administration ran a consultation to confirm its plans for the LIBOR cessation that concluded on 25 January 2021. The outcome of this consultation, coupled with an announcement from the UK FCA, could trigger the fixing of the International Swaps and Derivatives Association (ISDA) fallback five-year median spreads.

Based on the methodology of the compounded-in-arrears process, we know when trades will transition if they have fallback applied to them at LIBOR cessation. For trades with non-dollar currencies, it's at the end of 2021. For the dollar-currency trades, it's expected to be at the end of June 2023.

Fallbacks – from Alternative Reference Rates Committee (ARRC) to system fallbacks – are great risk mitigation initiatives. They deliver standardized language and customer placement resources through a rate source in a less-invasive way. Such language is injected into a large population of trades via standardized protocols. And they're triggered based on predefined events, which go hand-in-hand with regulatory statements and planned actions.

But they are not without their operational considerations. Many firms involved in the creation and promotion of fallbacks have described them using an analogy of seatbelts. Yes, seatbelts will save you, but they don't ensure a smooth ride.

You do not want to replace contractual or legal risk with large-scale-operational risk. For firms that plan to keep large populations of LIBOR trades up to and past cessation, there will be potential challenges on the regulatory reporting side.

It's a changing risk profile of a nominally unchanged trade, which is operationally tricky. There are potential pricing difficulties. They aren't insurmountable, but they will add to the complexities of achieving the fungibility of fallback LIBOR.

Will some firms not adhere to protocols? Hear more in the full **webinar** recording.

Q: What are some best practices firms can put in place from an operations standpoint to promote a voluntary, proactive transition?

A: The operations layer is really where legal contract language meets business and technology – where trade conventions and economics get converted into cash flows. A deep amendment of economic trade terms rarely is easily translated into systems and operational procedures. That's particularly true in the case of the LIBOR transition.

One key tip is to understand the transactions that your firm must execute. What does the language say today? How would contracts behave if you did nothing? How would they behave with fallback language?

Another piece of advice is to look proactively at your systems and internal processes. What are they capable of supporting and in what volumes? We've seen dependencies that limit when certain systems can support significant new transactions in Risk-Free Rates (RFR) products. You need to anticipate.

Lastly, make sure you understand the counterparties involved. Is this an isolated transaction? Is it a trading position? Is it a hedge of an existing loan? Are there specific needs on the other side? Does the counterparty understand the LIBOR transition? Make sure you think about what would be a mutually acceptable, long-term solution for all parties involved, rather than a quick fix.

Learn more about transitioning and migrating portfolios. Click to hear the full **webinar** recording.

Q: What should firms focus on in 2021?

A: Coordination and cooperation will be key. Try to facilitate conversations between groups. Have forums, join working groups that deal with LIBOR transition, talk to each other – because in every trade, there is someone else involved. You can't be successful in a silo.

Despite the fact that there is an extension, there is no reason to wait. If you want to turn rates, you've got to trade the underlying derivatives. The faster trading starts, the faster we get to a liquid market. The transition for legacy books will proceed much more smoothly if you plan ahead or make the conscious choice to wait for fallbacks to be invoked. The US-dollar-LIBOR extension was put in place to run down legacy portfolios, but your new transactions should all be on the new rates. The faster you can get up and running, the better.

This year, firms should move forward with informed business decisions. The year 2021 needs to be one of thoughtful action, working together with your firm, the industry, your clients and your counterparties so that the actual LIBOR cessation becomes a non-event. That's really the goal.

Click for more details and to hear the panel's answers to questions from attendees.

626463486-0121-JH