Trading the New RFRs, Fair Value Considerations

The transition away from the London Inter-bank Offered Rates (LIBOR) is impacting many layers within global financial markets, with banking institutions facing a major change.

IHS Markit recorded a series of webinars to help firms navigate the final steps of the transition. In our latest recording, Trading the New RFRs, Fair Value Considerations, IHS Markit experts and industry leaders reviewed some of the challenges relating to fair value calculations for firms impacted by the LIBOR transition.

Q: What are the key challenges going into the last phases of the transition in terms of maintaining fair value?

A: There are many challenges when it comes to knowing how the market is going to evolve and progress and how quickly changes will get adopted by clients.

The change is impacting many aspects of the overall market. Loans, credit cards, swaps, and bonds are all indexed to LIBOR. Many different market conventions and coupon calculations are emerging to adopt the new Risk-Free Rates (RFRs). Reams of existing documents need to be updated.

Broadly speaking, the industry needs to make sure it has approvals in place to trade what are effectively new products, referencing new rates. Much progress has been made, but there's plenty to do this year.

Hear more about the intricacies of the changes coming to the market in 2021 and where one bank is allocating critical resources in advance.
Q: Some market segments have struggled to adopt the new RFRs. What’s the current liquidity across derivative cash loans?

A: Adoption has fluctuated among differing currencies. For example, in the United Kingdom, the progression has accelerated to some two-thirds of the market in linear derivatives, compared to one-third in LIBOR. A very active regulatory environment—with deadlines to cease LIBOR lending—helped catalyze that market.

Looking at a comparable timeline, the United States has not seen the same in terms of new transactions. Still, markets can ramp up relatively quickly and there are huge, behind-the-scenes infrastructure efforts at play. There are optimistic signs. For example, the so-called “Big Bang” milestone for discounting in October 2020 was relatively painless. The huge efforts that went into getting ready for that deadline provide encouragement for the market going forward.

Find out about major regulatory hurdles the market will face in the final phases of the LIBOR transition.

Q: How will banks handle fair value and costs for positions in the transition of U.S. LIBOR exposure?

A: The market is going to determine its standard unit of risk. At the moment, LIBOR indices prevail. But, the world is changing and liquidity patterns are going to transition. What’s the duration? What’s the degree of disruption? Banks are still looking for clarity, but they will adapt to it.

We will see the introduction of new basis risks. For example, a coupon could reference a two-day look back or a five-day look back. We’ll see compounding and averaging features. These new risks will need to be valued and that may be difficult until liquidity patterns emerge or fallback conventions complete.

Banks are investing considerable resources and time navigating this transition stage. Tough legacy positions will also be impacted by the transition. Some of them might roll off —somewhat of an unintended consequence of the extension of some LIBOR, in that these positions will not need to be managed. However, a large part will still require attention and fair valuing. Those positions will become more and more difficult as we approach the cessation of many LIBOR benchmarks.

On the whole, market activity will need to broaden past just banking institutions over the next couple years. There will need to be creation of a virtual, virtuous circle in which, as more risk and more demand for hedges are created, the market sees better price transparency. That understanding will increase confidence amongst issuers. It will need to be the whole market—buy side, sell side, investors, borrowers—all looking to get into RFRs and manage them accordingly.
Q: The utilization of multiple fallbacks is a critical piece of the LIBOR transition. Amid this, how will compensation work?

A: Cleared trades and discounting rates have been changed with different variations on compensation treatment. For example, the July 2020 change in discounting conventions for EUR-cleared swaps at the main clearing houses prompted only cash compensation. In other instances, we've noted cash and risk compensation.

There's been greater clarity on how compensation will be handled for cleared swaps. With other products, such as swaptions, we are almost down to the 11th hour. There is similar uncertainty for swaptions that can settle into swaps. Not allowing cleared trades to use fallback rates can create an inconsistency for those sorts of swaptions, when compared to bilateral transactions. Stock compensation is also unclear as we start to move and transition Latin American currencies in rates products or even different product sets. There's much still unknown in terms of treatments, but we do see more certainty around cleared products, because clearing houses can set better rules.

Q: Heading into the final stretch, what does the market need to do to prepare?

A: Given all that's been discussed in today's webinar, this transition is a pretty major lift. Let's get cracking. The change isn't being dropped from above overnight—we've been working on this for a long time, migrating things and transitioning. The work continues. It is key to make sure we're positioned to keep up with the market evolution. There will be more clarity and we need to be able to adapt.

Liquidity is important, particularly when we start looking at anything that's not a swap. For example, options are not being traded very much. It's important to start trading products. That will sort out a lot of issues and start driving systems to be ready.

At the end of the day, it will be imperative to solve what we can. If we wait for all the problems and their solutions to be out on the table, we'll be looking at this in 2025. The LIBOR transition is not going away and more complexity will emerge as we go through it.

Hear more on fair value considerations ahead of the LIBOR transition, including the panel’s answers to questions from attendees.