Libor Replacement

Impact on Australian Corporates

Shehan Fonseka, Director, Treasury & Capital Markets Advisory
Alastair Harris, Director, Treasury & Capital Markets Advisory

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Background

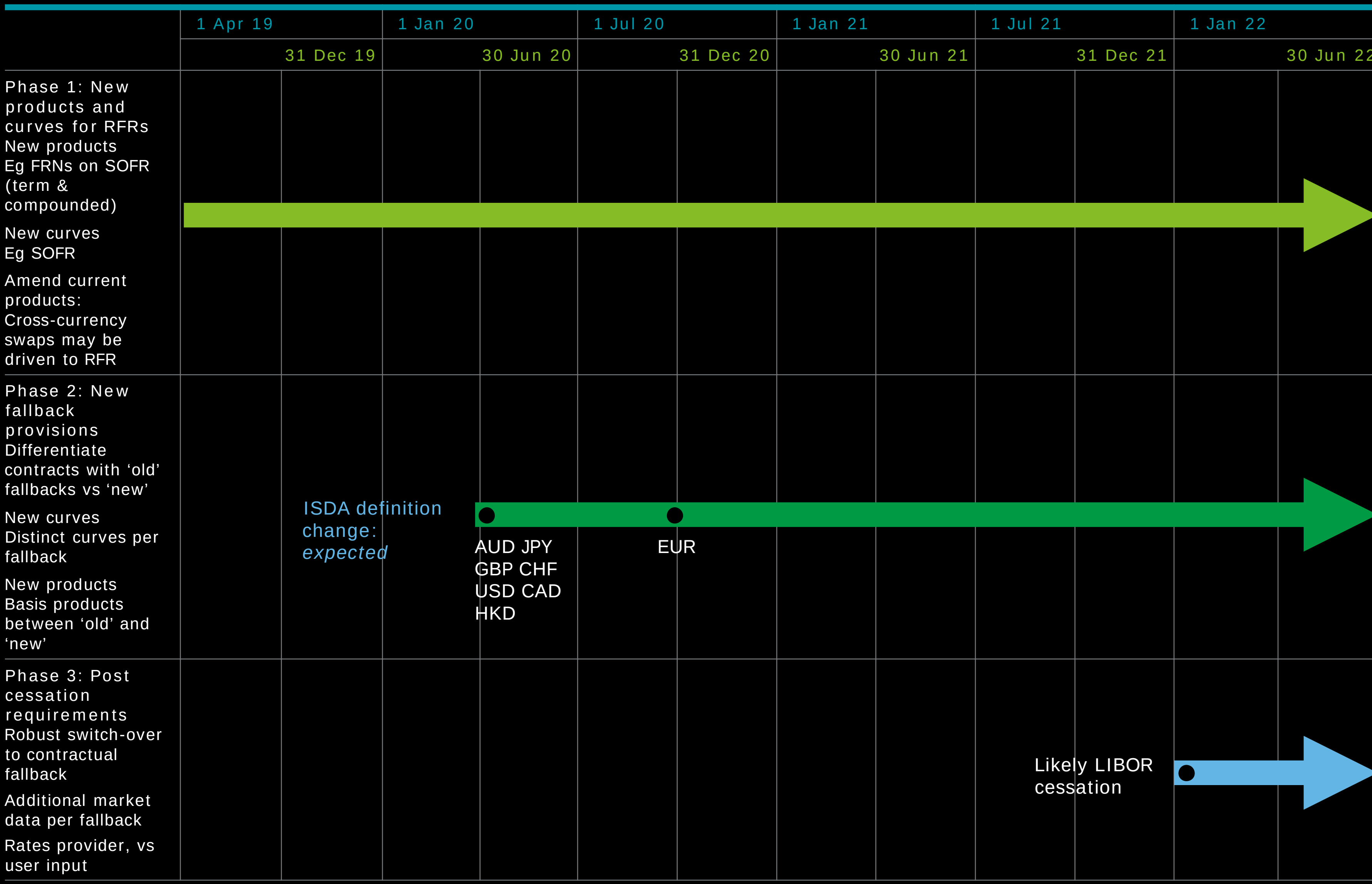
How did we get here?

- Transition has been on the global agenda since 2014
- July 2017 – Andrew Bailey announces the FCA won't compel panel banks to contribute to LIBOR after 2021
- July 2018 – Andrew Bailey announced that the Sterling RFR working group launched a consultation on a term structure for SONIA
- July 2018 – J. Christopher Giancarlo from the CFTC provided opening remarks on the transition from LIBOR to SOFR
- September 2018 – The FCA and PRA issued a "Dear CEO Letter" requiring the Board to sign-off on a comprehensive risk assessment of LIBOR transition
- December 2018 – The ECB Working Group for EUR RFRs published proposed transition paths from EONIA to ESTER
- January 2019 – Edwin Schooling Latter from FCA announced that market participants should not rely on the availability of an option to use LIBOR for legacy contracts
- January 2019 – IASB issued a proposal on IBOR Transition and its effects on Financial Reporting
- May 2019 – ASIC issued a "Dear CEO Letter" to several major financial institutions requesting an understanding of the preparedness for the LIBOR transition

"Since the financial crisis, Libor really has become the rate at which banks don't lend to each other."

Mark Carney, Governor, Bank of England, May 2018

Expected transition approach



The Risk Free Rate Landscape

Currency	Reference Benchmark	Alternative RFR	Type
AUD	BBSW	RBA Cash Rate	Unsecured
CAD	CDOR	CORRA	Secured
CHF	LIBOR	SARON	Secured
EUR	Euribor	ESTER**	Unsecured
GBP	LIBOR	SONIA~	Unsecured
JPY	LIBOR	TONA	Unsecured
USD	LIBOR	SOFR*	Secured

~ Reformed | * New | ** To be created

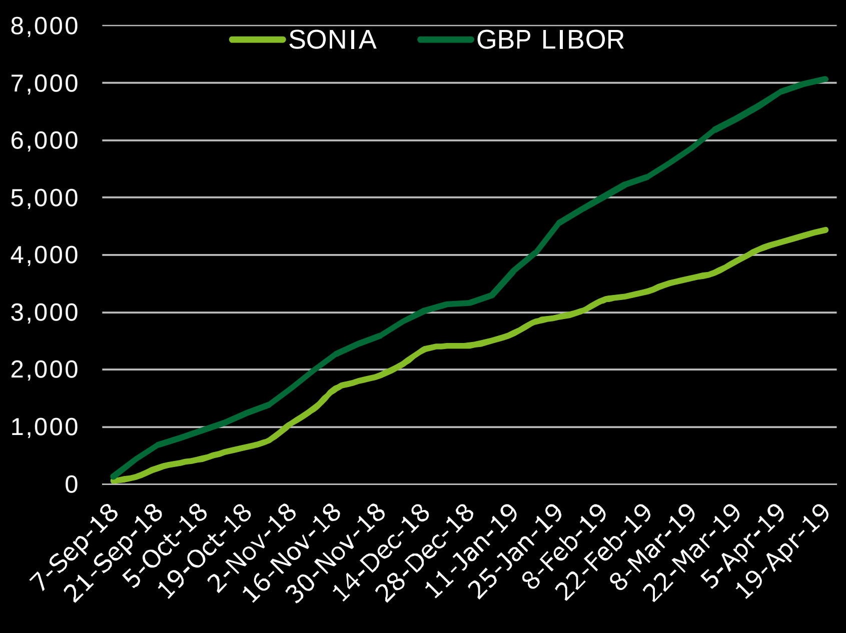
What has the take-up been like?

The pace is gathering

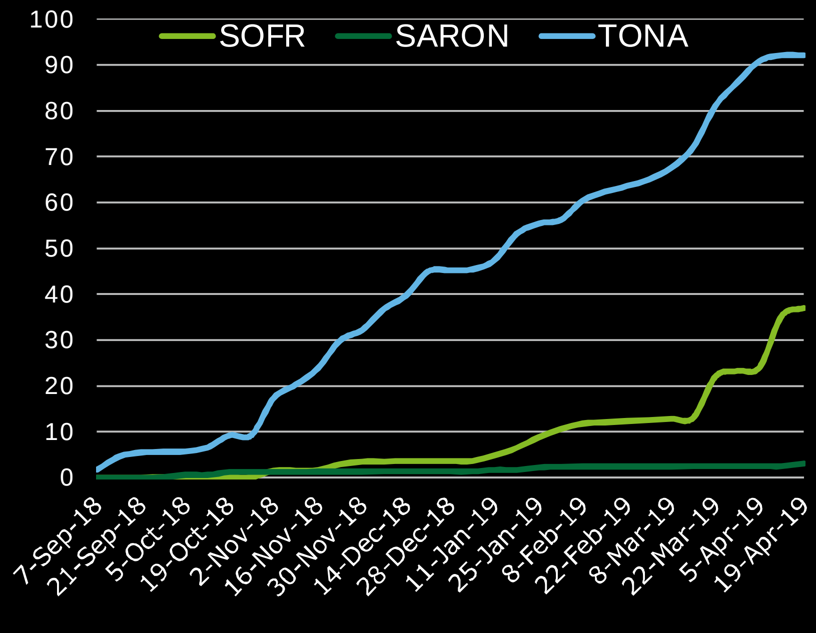
CBA issued a FRN referencing SONIA on 3 December 2018, and ANZ issued a covered bond referencing SONIA on 11 January 2019.

22 institutions have issued a total of $81 billion notional in floating rate instruments tied to SOFR (source: Bloomberg and CME).

GBP cumulative volume (US$bn)



Cumulative volume (US$bn)



Fallbacks: Current situation

Current Contractual basis

Current ISDA definitions require obtaining quotes from major banks. If one or none received, they are currently generally not specified.

For BBSW, this scenario results in the calculation agent determining the rate having regard to comparable indices then available.

For Wholesale Loans, this is varied:

- Obtain quotes from banks. If none received it would convert to an alternative base rate (prime rate). Or, the cost of funds rate of the lender(s).
- Or, historic rates.

For FRNs, this is again varied:

- The calculation agent would poll banks for quotes.
- Or, convert to a fixed-rate based on last IBOR rate.
- For MBSs, same procedure except the note holder (e.g. Fannie Mae) could name a successor rate.

These were not intended for a permanent cessation, and are not consistent across, or necessarily within, product types.

If this were to happen now – what would the impact be on you?

ISDA Fallback methodology

A recent industry consultation was held to solicit feedback on the preferred fallbacks to incorporate into standard documentation going forward for GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, and BBSW

This is not the same as the development of new RFR instruments, where the liquidity is expected to grow

The fallbacks are characterised as a designated Risk Free Rate (RFR) adjusted for Term + Credit Spread

Term spread adjustment

Compounded Setting in Arrears/Advance

$$ARR_f(t) = \frac{1}{\delta_f}\left(\prod_{u=T}^{T+f-1\text{bd}} (1+\delta_u RFR_u) - 1\right)$$

Convexity Adjusted

$$COR_f(t) = RFR_t(1+\delta_1 RFR_t)^{\delta_f/\delta_1}$$

Spot

$$SOR_f(t) = RFR_t$$

Credit spread adjustment

Forward Spread

$$CS_f(s,t) = FL_f(s,t) - FR_f(s,t)$$

Historical Median

$$CS_f(t_2) = \frac{1}{L}\int_{t_0-L}^{t_0} \left(L_f(t) - R_f(t)\right)$$

Spot

$$CS_f(t_0) = L_f(t_0) - R_f(t_0)$$

The results are expected to be incorporated into the ISDA 2006 definitions in 2020 Q1; and would form the Priority fallback within the ISDA Benchmark Supplement calculation waterfall

One world – Many rates

IBOR

- In advance.
- Term based, with various maturities.
- Interbank Credit.

- "Fallback" IBOR
  - Old
  - New
  - Across product

RFR

- Overnight.
- Risk-free.
- For instruments paying term, some variants include:
  – Compounding, in arrears, with a lag to allow for settlement funding
  – Backward looking, in advance.

Term RFR

- Typically anchored to an RFR and utilising the forward derivatives thereon to derive a forward looking term structure.
- No interbank credit

And bear in mind, that each of these may employ different waterfalls, and embed different fallbacks.

Implications of benchmark reform for AUS and NZ markets

Benchmark Robustness

ASX BBSW change in methodology in May 2018, introducing a waterfall approach, with the pinnacle being a Volume Weighted Average Price.

NZFMA reviewing BKBM against IOSCO Benchmark Principles.

BBSW Liquidity from Europe

BBSW in first round of considerations for equivalence for EU BMR as a Third Country Administrator – relevant for ensuring continued liquidity in BBSW from EU post 2021.

1m BBSW – experiencing liquidity issues

“users of 1-month BBSW should be preparing to use alternative benchmarks” Christopher Kent, 19 March 2019

ASX, in order to reduce the volatility experienced have introduced a new methodology that tightens the window, which has the effect of further reducing the eligible trades, such that the VWAP method is expected 35% of the time

The RBA has continued to make public statements regarding the robustness of BBSW, and in a recent conference made it clear that they will only support the new fallback language for securities eligible in their market operations.

Definitions Replacement – Contract Certainty

Replacement ISDA 2006 fallback definitions will be announced in 2020 Q1.

This is irrespective of view of current robustness, but to provide contract certainty in the event of a permanent cessation, and to reference an RFR.

The market standard in liquidity will be on the new ISDA 2006 definitions – you need to evaluate, and be ready to adopt the new definitions in your confirmation process.

Cross Currency Market – Importing changes

"As market participants transition from referencing LIBOR to RFRs, there may be some corresponding migration away from BBSW towards the Cash Rate. This will depend on how international markets for products such as derivatives and syndicated loans end up transitioning away from LIBOR.“

FSB progress report, 14 November 2018

This will necessitate an additional swap being transacted.

Who's Leading the Charge

Regulators, including ASIC, FCA, HKMA, MAS and FINMA, are putting pressure on their banks to ensure they are planning – with a request generally covering the following aspects

Board-approval of the firms' assessment of key risks relating to LIBOR discontinuation

Detailing the action plan to mitigate those risks

Considering an appropriately wide range of scenarios and impacts and including a quantification of LIBOR exposures

Banks are responding to the market developments by mobilising their programme, taking inventory internally, stopping the problem from getting worse, and engaging externally

If you’re not at the table, you’re on the menu

What does it mean for Australian Companies?

Considerations for New Issuers

Transact debt and derivatives using new benchmark i.e. SOFR

Pros

- Financial institutions are already transacting SOFR debt and derivatives e.g. ANZ, MetLife.
- Cost of RFR bonds appears to less than Libor – ability to lower cost of debt.
- Avoid Libor transition issues in 2022

Cons

- Can your systems and models handle the new benchmarks.
- Difficulty obtaining forward curves to fair value deals and forecast interest expenses.
- Update to policy and risk strategy will most likely be required.
- Are the new benchmarks liquid enough – ability to exit positions.

Continue to Transact Libor based debt & derivatives

Pros

- Still a deep and liquid market and likely to be that way post 2021.
- Current systems and risk models set up to handle Libor.
- No change to existing strategy or policy required.

Cons

- Will eventually need to transition to new benchmark.
- Creates future uncertainty around cost of funding i.e. will there be additional margins after 2021.
- May need to transact additional basis derivatives which use up credit lines.
- Need to ensure fall back provisions are clearly articulated for debt and derivatives.

  Are they the same?

Consideration for Existing Issuers

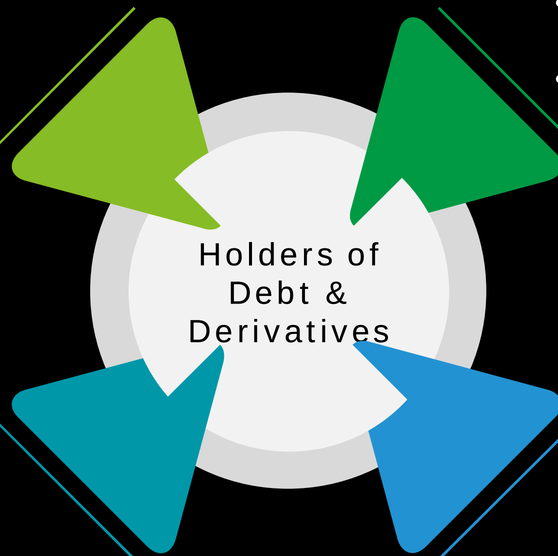
Focus is on debt and derivative which currently reference Libor and mature after 2021

What is your Fall Back rate

- Is it clearly articulated in agreements? May need to negotiate terms with your banks.
- Is it the same between your debt and derivatives?
- May need to strengthen/clarify them.

Financial Risk Implications

- Potential increase in cost of funding i.e. opportunity for banks to increase margins.
- MTM of derivative could change overnight on transition.
- Possible mismatch between debt & derivative due to different fall back rates.
- Lack of liquidity may make exiting positions harder/costlier.



Ability to refinance

- Will prices exist for new RFR rates, out to the tenors required.
- Could impact ability to raise long term debt and transact corresponding hedges.

Operational considerations

- Can existing systems/models handle fall back rates and new RFR benchmarks?
- Are your credit lines large enough to handle additional basis swaps that may be required post 2021.

Other Operational Considerations

Settlements

- Access to new benchmark prices (i.e. fall back and new RFR rates) to confirm bank settlement amounts.
- Can systems handle rates set in arrears e.g. SARON?

Risk Reporting

- Do risk models need to be updated for new benchmarks i.e. fall back and RFR rates?
- Where debt and derivative benchmarks differ, is this being picked up?
- Do current risk limits cater for a potential future mismatch in rates?

Documentation

- Need to consider potential updates to derivative and debt documentation e.g. proposed update for 2006 ISDA. *Need to involve legal*
- Ability to access all relevant historical documentation.

Operational Considerations – Accounting

IASB is looking at Libor replacement in 2 phases:

- Phase 1 – issues leading up to reform.
- Phase 2 – Issues after reform.

ED issued in May in relation to phase 1, with final amendments published in late 2019.

Hedge Accounting

Can continue hedge accounting even if reference benchmark changes. Highly probable hedged item will not be impacted.

Hedge Ineffectiveness

No relief provided for ineffectiveness arising from different fall back benchmarks.

Measurement of Fair Value

Swaps could become level 3 derivative in the absence of a liquid curve.

Require additional disclosure and sensitivities.

No relief provided for this.

Measurement of Debt

Change in benchmark triggers de-recognition considerations i.e. 10% rule. If change in fair value of debt >10%, a de-recognition occurs which impacts P&L.

No relief provided for this.

Impact on other accounting standards

Mainly revolves around discount rate used to calculate balances e.g. leases, impairment calculations, etc.

What should corporates do?

Priorities	Challenges
Achieve senior level understanding (i.e. CFO, CEO and Board), support and sponsorship	• Convincing stakeholders of the scale and complexity of IBOR Reform, and the need to understand the impacts whilst the process is ongoing.
Undertake an impact analysis with a focus on strategy, systems, processes and documentation	• Resources, can you team handle it or do you need more resources. • Where is all your relevant documentation e.g. ISDA, loan docs, term sheets, etc. • Getting engagement from other parts of the business e.g. legal.
Stop the problem getting worse	• Updating fallback provisions for new trades/contracts. • Engage with system vendors and bank counterparties to understand what they are doing to support the transition.
Engage externally, monitor industry developments and the response of banks and competitors	• Understanding how the market is responding to the issue especially your bank counterparties. • Educating and managing stakeholders

Questions?

https://www2.deloitte.com/content/campaigns/uk/ibor/ibor/iborreform.html

Contacts

Shehan Fonseka
Director

+61 4 0298 9858
sfonseka@deloitte.com.au

Alastair Harris
Director

+61 2 9322 7989
alharris@deloitte.com.au