Financial Markets INSIGHTS™

USD IBOR transition is coming

The Realization Group

Executive summary

The move away from interbank offered rates (IBORs) is one of the most significant and far-reaching changes in banking and financial services for a generation. Thousands of work-hours have already been spent in preparation for the new post-LIBOR paradigm.

While the deadline for the transition of non-USD trades passed last year, the major hurdle remains: safely and efficiently transitioning the vast number of USD-denominated trades away from LIBOR and to the new regime of 'risk-free rates' (RFRs).

The IBOR transition has been a trial by fire for many organisations, requiring a high degree of cross-functional collaboration not only to understand the implications of the change but to implement it. The tendrils of IBOR are embedded deep within the industry, and the transition affects every part of the impacted businesses, from board level to IT.

This paper explores the realities of the IBOR transition from the perspectives of a range of market participants. It asks what has worked, what remains to be done, and how the lessons learned during the transition can help the industry manage complex change programmes better.

Key findings:

- *While the transition for non-USD trades was achieved in a timely manner, the USD deadline will be far more complex, more computationally demanding, and potentially more disruptive.*
- *This will only be achieved through close cross-functional collaboration, and through co-operation between market participants.*
- *Modelling, fallback processes, and other technical aspects of re-papering trades remain an immediate priority.*
- *Regulators can do more to support industry through the transition. A joined-up approach amongst regional regulators is crucial.*
- *IBOR presents an opportunity for industry to manage complex change better in the future. The organisations that manage change most efficiently are likely to be those that adopt an augmented model in which in-house resource is complemented by senior-level third-party expertise.*

Our contributors are:

Alan Vear*, a director at Brickendon Consulting, a transformational change management consultancy.*

Alastair Rutherford*, managing director of Ascendant Strategy, a consulting firm specialising in post-trade transformation.*

Nabonita Banerjee*, an executive director at Nomura specialising in global markets and regulatory change.*

Steven Marshall*, a consultant specialising in XVA and the founder of Tensilo Limited.*

Eric Peng*, senior vice president for core analytics at FINCAD.*

The lay of the post-LIBOR land

IBORs will soon no longer be with us. The post-2008 liquidity crisis, combined with manipulation scandals and lingering concerns about the integrity of the data on which they were based, eventually spelled the end for inter-bank offered rates (IBORs) and their fundamental role in the financial system.

In 2020 the Bank of England and the FCA announced a timetable for the retirement of the London IBOR which, following a Herculean effort on the part of industry, eventually occurred on 31 December 2021. Now, the next major deadline looms: the transition of USD-denominated settings, which will occur on 30 June 2023.

Alan Vear, director at Brickendon, is concerned that some parts of the industry are under-estimating the scale of the challenge still faced.

"A number of organisations feel that the work for the USD transition was largely completed through their non-USD activities." he says. "Where organisations had the luxury of concentrating on all currencies and impacts this may well be true. However for most the focus was on making non-USD a success, and to leave validating the process against USD until 2022."

He continues: "There will continue to be model update requirements for USD products that will need to be tested, validated, and implemented. This is rarely a quick process, and should be in place well before the fallback performance can be confirmed."

"You really want to be testing your model updates ahead of validating your fallback performance against a compressed portfolio, because they're all so tightly interconnected."

Alan Vear, Brickendon

There are also challenges that are going to be really USD-specific, Vear says. "Things like the Trade Reporting requirements from the US regulators have yet to be set. These are likely to follow the same approximate requirements that were applied to the non-USD transition, however there is also a long list of system 'tweaks' that will need to be planned before the USD volumes can be managed with confidence. Ultimately, if you're relying on your historic non-USD work for USD readiness you'll need to be very confident as the USD volumes will exaggerate any issues."

For Vear, laying the groundwork for the technical side of the transition has been absolutely crucial. Addressing other organisations, he says: "You really want to be testing your model updates ahead of validating your fallback performance against a compressed portfolio, because they're all so tightly interconnected. It's really important to get a good structural plan in place for this."

While the resourcing required to achieve a timely transition is unlikely to be an issue for the largest firms, that picture changes further downstream. In **Steven Marshall's** view, while the banks have been the focus of the transition, "arguably they are not the main users of the index. We've forgotten about the very significant loan market, and the use of the derivatives on the back of that. If you speak to some of the people in, for example, private equity, who have huge asset portfolios against which there is a huge amount of debt issued – there are major issues facing them."

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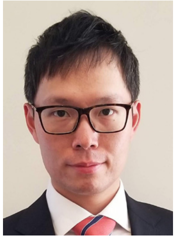
Steven Marshall, Tensilo Limited

Beyond the transition

As FINCAD's **Eric Peng** says, the challenges associated with the transition will not actually end with the transition itself. The move away from a single benchmark rate towards what could be myriad competing alternatives will impose operational hurdles. The "operational convenience" of a single rate will end. Now, "making things much more complicated is the fact that there is more fragmentation of the markets and a proliferation of competing benchmarks."

He continues: "Where you used to deal with one single benchmark, now you have this bifurcation of markets. For example the loan and cash market on the one side is gravitating much more towards Term SOFR, whereas in the interdealer markets, where all the derivatives are traded, you're looking mainly at overnight compounded SOFR. There's a mismatch, and it creates all sorts of issues like basis risk."



"Making things much more complicated is the fact that there is much more fragmentation of the markets and a proliferation of different kinds of competing benchmarks."

Eric Peng, FINCAD

The role of regulators

Close and co-operative relationships between industry and regulators is a crucial prerequisite for the safe and efficient functioning of the market. Deepening and improving that relationship is one of the continuing priorities for industry and, given the scale of the challenge it poses, the IBOR transition has been uniquely useful in highlighting some ways in which that might happen.

Several respondents suggested that regulators could have done far more to explain how regulated firms were expected to comply, and the associated reporting requirements. Alan Vear says: "On the non-USD work, we really didn't get solid guidance from the regional regulators on what they wanted to know. In the end we produced lists and reports of trades that were leveraging the fallback and sent them to all of the regulators impacted – without really knowing, to be perfectly honest, whether they wanted those reports. We knew of half a dozen that desperately wanted to see who was going to be using the fallbacks, but it wasn't consistent [between regulators]. It's almost as if the regional regulators hadn't spoken to each other at all on this."

Banerjee agrees: "Initially, I think people didn't understand what the regulators wanted them to do, and this caused some confusion. Compliance is crucial and it's everyone's top priority, so there was a bit of work at the outset to identify what was actually required. And of course, senior management were being held responsible for implementation."

Reporting will remain a challenge beyond the transition, Vear says. "Many of the larger organisations feed their disclosures and regulatory reporting from a high number of source systems," he continues. "Although FO impacts in the cleared markets are largely neutralised through the compensation structure, and we hear that the CCPs are looking to reduce the impact on notionals, the production of data for the regulators and for shareholder reporting remains a time consuming challenge, and potentially quite manual for a period."

Change management – lessons learned

Beyond the regulators, and indeed beyond IBOR, this long-running transition also presents a crucial opportunity for the industry to take stock of the way it manages change. Forward-thinking organisations are already beginning their lessons-learned exercises, and the new knowledge developed during the transition will bolster change management best practices throughout the industry.

IBOR has become a particular crucible for learning because of its structural importance, and because timely compliance is non-negotiable. As **Nabonita Banerjee** says, "One thing that differentiates a transformational programme versus a regulatory change programme is that the resistance is minimal." In the case of the former, "there will be various corporate functions who would say, 'well, that's not my priority,' or, 'we don't have the money, we don't have the resources,' and so on. But with respect to a regulatory programme, especially something like LIBOR, or Brexit, or global margin – these kinds of very, very big programmes – you have to find a way to manage it. And what happens is you have to drop some other things."

"This will be an important lesson as further large-scale regulatory change comes down the track, be that [related to] climate change, be it Brexit, or be it IBOR – the horizon is big."

Nabonita Banerjee, Nomura

For Banerjee, one of the crucial lessons is to "take regulators seriously" and to act on their instructions in a manner that is operationally efficient. A smaller team, drawn from internal resources and augmented with outside expertise, can be the most effective way to tackle this sort of work, she says. "There are a lot of banks out there, a lot of consultancy firms, all the Big Four, who made a lot of money because [of the sense that] you had to have big programme teams to do this. We wanted to keep a smaller team, and only spend money when it's going to add value – not for the sake of it."

Banerjee also says that timing is crucial. Some functions, such as communications, may be able to get a head start on processes, while technical tasks are carried out in the background. "You can prepare yourselves ahead of time," she says. "Some things that aren't client-related can be front-loaded, rather than wait until the end." This will be an important lesson as further large-scale regulatory change comes down the track, "be that [related to] climate change, be it Brexit, or be it IBOR – the horizon is big."

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Alastair Rutherford, Ascendant Strategy

Alastair Rutherford thinks complex change programmes are only going to become more challenging, at least in the immediate term. "Firms find themselves coming off the back of a couple of decades of cost cutting," he says, "and are really very thin both in terms of expertise and bandwidth to execute whatever the plan is. The real risk around not staffing up properly for execution is the risk of not completing on time. And as we know, with regulations, that there's a drop-dead date, and if you missed that you're in trouble."

One option, Rutherford says, is to "hand it to a third party to drive everything. But again, this has risk, because internally no one properly owns it. I think the optimal thing here is somewhere in between, where you've got proper ownership within the organisation, but you've recognised where your shortfalls are in terms of expertise and execution, and you're effectively augmenting your internal capability such that it exists with external expertise. But that external expertise needs to be at a sufficiently senior and knowledgeable level that they don't need to have their hands held in order to move forward."

Conclusion

Market participants will continue to manage the IBOR transition as best they can, and there is little doubt that the Herculean efforts of industry will continue. The 'drop-dead' date for completion leaves little to no room for error or delay. The importance of that deadline is reflected in the fact that the work associated with meeting it is being planned and directed at board level. Meeting the requirements of the IBOR transition is business-critical.

While it is true that important work has already been completed with regard to non-USD transactions, it is a significant mistake to assume that any market participant is home and dry. The USD transition is far more complex, more computationally intensive, and farther-reaching. If they are not already doing so, organisations should immediately prioritise this phase of the IBOR transition. In many cases this will require input from third-party consultants and specialists, particularly when there is limited in-house technical resource or expertise.

Beyond the transition date itself, though, there are still questions about the post-IBOR landscape. The fragmentation of global markets continues, and the proliferation of competing benchmarks and standards will throw up new and unexpected challenges. Many of these will be technical. The importance of intelligent and mindful systems design will be paramount; the organisations that not only cope but thrive will be those that focus on interoperability, futureproofing, and an agile approach to change. Following years of cost-cutting in many businesses, and faced with a global economic maelstrom, market participants need to focus even more intently on their capacity to manage change.

IBOR is the most important priority facing capital markets, but it will not be the last change of its kind. By bolstering their change management capabilities both in-house and through third parties, organisations can put themselves on the best possible footing to face future transitions as they materialise.

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