Treasury Trends

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LIBOR transition: What you need to know

Some will have noticed the additional disclosures that now accompany bank interest rate hedging documentation, while others may have seen commentary from the International Swaps and Derivatives Association, Inc. (ISDA) regarding the recent update to the 2006 ISDA Definitions, or spotted new functionality in their Treasury Management System. These changes attest to the fact that LIBOR's days are numbered with much of the global financial system on the verge of the new Risk Free Rate (RFR) world. Despite recent speculation that LIBOR's final retirement date might now be delayed until mid-2023 (18 months beyond the original end of 2021 date), the influx in treasury webinars and news coverage in recent months signals that transition progress is finally accelerating.

Although much of the technical detail can be confined to those responsible for maintaining the plumbing of the financial services industry, those corporates with funding or derivative contracts referencing key interbank offered rates (IBORs) should be assessing any potential operational or legal implications and setting a migration plan well ahead of the benchmark transition. Even if your financial products do not reference LIBOR, you do need to consider the reforms being undertaken in other benchmark rates as you will likely be asked to amend your contracts to include new fallback language.

Key Points

- **The global transition away from LIBOR is progressing, although the final retirement date may be delayed until mid-2023.**
- **The key Australasian interest rates, BKBM and BBSW, are not changing but alternative risk free rates may become more widely used following the global transition away from LIBOR.**
- **ISDA has recently updated its fallback provisions, providing certainty about the replacement rate when LIBOR ends.**
- **Financial institutions are expected to be offering non-LIBOR linked loans to customers by early next year.**

New ISDA contractual fallbacks – a crucial step

A key milestone was achieved in October, when ISDA released 'Supplement 70 to the 2006 ISDA Definitions' and the 'ISDA 2020 IBOR Fallbacks Protocol'. These are known as the somewhat dystopian sounding 'Supplement 70' and 'the Protocol'. Supplement 70 will automatically apply for new derivative transactions entered into from 25 January 2021 and essentially makes future interest rate derivative documentation more robust by defining new fallback benchmark rates. The protocol covers fallback rates on legacy derivative contracts and only applies if both parties to the legacy transaction agree to the protocol. The fallback provisions outline how a replacement floating interest rate will be calculated if the original benchmark rate is either temporarily or permanently unavailable. The supplement and protocol cover fallback rates for 10 currencies, including BBSW. A fallback for New Zealand's BKBM is expected to be published in an additional supplement and protocol.

Regulators on both sides of the Tasman are encouraging broad and timely adherence to the protocol in order to mitigate the risk of contractual disputes when LIBOR comes to an end. While parties should first consider how the fallback will impact the hedge and the related loan the hedge is linked to, adoption of the protocol is likely to be widespread.

What rate will be used instead?

In Australia and New Zealand, the floating interest rate benchmarks, BBSW and BKBM, are anchored to real transactions at traded

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prices, so are relatively robust and are not immediately changing, however Risk Free Rates are being published and will continue to co-exist with BBSW and BKBM. In Australia, BBSW will co-exist with the Reserve Bank of Australia's Cash Rate (commonly known as AONIA) as the alternative RFR for the Australian dollar. In New Zealand, BKBM will co-exist with the Reserve Bank of New Zealand's Official Cash Rate (OCR) as the alternative RFR for the New Zealand dollar. As global markets transition away from using LIBOR to RFRs, there is potential for the Australasian RFRs to become more widely referenced.

Other parts of the world, however, are going to see big changes. The move away from LIBOR to a RFR approach is probably the biggest change in interest rate markets since the advent of derivatives. The fundamental way that floating interest is calculated is changing. They are called Risk Free Rates because they are underlying rates for overnight borrowing that do not include any credit risk for the banks (minimal anyway) or a term structure (i.e. overnight versus three month tenor, for example).

To determine the rate for the relevant tenor, the daily RFR needs to be compounded throughout the period, which means the calculation is only known at the end of the period. This contrasts with the current LIBOR methodology, where the rate for the relevant period is determined in advance.

Essentially LIBOR is a forward looking rate set, whereas RFRs are backward looking, based on actual overnight rate sets. As well as this daily compounding, a spread adjustment is also calculated to account for the credit risk premium imbedded within LIBOR (unsecured bank-to-bank lending), versus the secured RFRs. The daily compounding and spread adjustments are combined to calculate the applicable Adjusted RFR covering the relevant tenor. Bloomberg has been selected by ISDA to calculate and publish the calculations related to LIBOR fallbacks.

Derivative valuation impacts

While the RFRs are intended to produce a result that is comparable to LIBOR, there will be a derivative valuation impact where the two curves do not perfectly align, and basis risk where the hedge and the underlying exposure do not migrate in exactly the same way. Valuation impacts will ultimately depend on the derivative portfolio makeup and the transition process and timing.

While some early modelling can already be undertaken, much of the analytics machinery, in terms of Treasury Management Systems and the like, is yet to be rolled out. There is also some expectation of convergence between the LIBOR rates and RFRs as the transition timeline approaches, potentially muting some of the derivative valuation consequences. The US Internal Revenue Service for example, has set out rules requiring the fair market value of the instrument, after the change, to be 'substantially equivalent' to what it was before the change.

While most New Zealand and Australian corporates will not be directly impacted, analysis by ASIC last year found that the aggregate notional LIBOR exposure in Australia was close to AUD10 trillion. Those with IBOR or multi-currency loans and derivative hedging therefore need to consider how the move to RFRs will impact risk management, internal processes and accounting treatment. Financial institutions are expected to be offering non-LIBOR linked loans to customers by early next year. Thankfully, for those worried about maintaining hedge relationships, the International Accounting Standards Board has completed its amendments to IFRS, providing some accounting relief where financial instruments are modified as a result of LIBOR reform.

Regardless, as the date for LIBOR replacement approaches, these changes will need to be anticipated and appropriately planned for, to ensure the necessary changes to legacy contracts are made and to enable a smooth transition.

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