

NOT SOFR AWAY: LIBOR TRANSITION BEGINS

AUTHORS

Oliver Wyman LIBOR Transition Team

NOT SOFR AWAY: LIBOR TRANSITION BEGINS

Transitioning away from LIBOR is likely to be a complex, expensive, and multi-year process. An important step occurred on April 3rd, when the Federal Reserve Bank of New York began publishing the Secured Overnight Funding Rate (SOFR), a new benchmark rate aimed as a replacement for USD LIBOR. The publication of SOFR allows institutions to proceed forward – and those that begin acting now will have the advantage of shaping the outcome and maximizing the time available to limit the impact of transition on the firm and its clients.

SOFR is an overnight collateralized rate based on daily repo transactions, typically over \$700 billion each day.¹ It was chosen by the Alternative Reference Rates Committee (ARRC) as the recommended alternative to USD LIBOR. SOFR complies with the International Organization of Securities Commission Principles for Financial Benchmarks and is based on a robust underlying market, in line with the Financial Stability Oversight Council and Financial Stability Board's mandate.

Many of the changes required to begin using SOFR are already in progress. This includes CME Group supporting SOFR futures trading and swaps clearing², as well as the Financial Accounting Standards Board proposing the eligibility of SOFR as a permissible US benchmark interest rate for hedge accounting³. However, a large volume of work remains for individual financial institutions, and this work should now begin in earnest.

Institutions need to determine how best to use SOFR and if need be develop alternative rates. It is also important to inventory exposures, speed up product development, and mobilize for transition of existing portfolios of LIBOR products. In parallel, firms should also initiate a client outreach and education process to prepare clients for the transition of existing products and pipeline of new product options.

IS SOFR AN ALTERNATIVE OR A REPLACEMENT?

There is a strong reason to believe that LIBOR will not be published in its current state after 2021. This has been recently reiterated by Andrew Bailey, of the UK's Financial Conduct Authority (FCA), in which he noted that the FCA has "is not going to use powers of compulsion towards submitters beyond 2021⁴." And while panel banks could voluntarily continue supporting LIBOR and Intercontinental Exchange (ICE), the LIBOR administrator, is proposing a new methodology to continue LIBOR⁵, it is clear that the direction of travel is to end LIBOR as it is published today.

1 SOFR includes tri-party repos sourced from Bank of New York Mellon and General Collateral Finance repos and FICC cleared bilateral repos sourced from The Deposit Trust & Clearing Corporation
<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report>

2 <http://www.cmegroup.com/trading/interest-rates/secured-overnight-financing-rate-futures.html>

3 http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176169744779

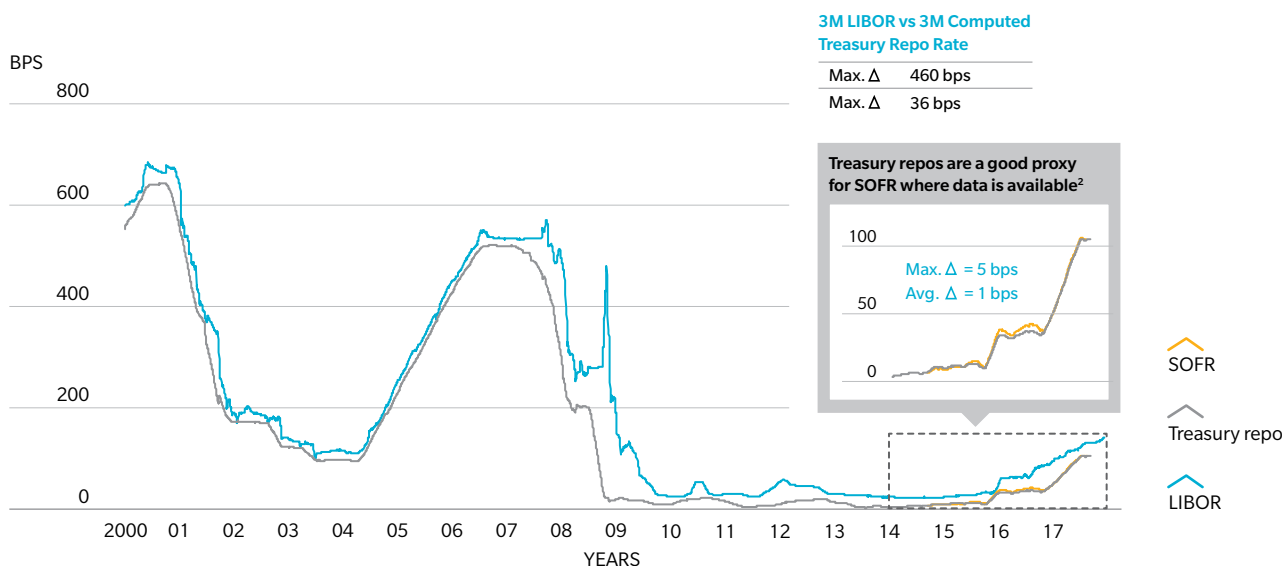
4 <https://www.fca.org.uk/news/speeches/recent-developments-financial-markets>

5 https://www.theice.com/publicdocs/ICE_LIBOR_Output_Statement.pdf

At this point SOFR is a recommended alternative for “certain new US dollar derivatives and other financial contracts.” There is no mandate to use it as a replacement for LIBOR, and in its current structure it may not actually be the most applicable rate for many products.

LIBOR transition needs to deal with the structural differences between LIBOR and the new rates. SOFR for example is not a rate-for-rate replacement. The structural differences, which are discussed in our prior report, [Changing the World’s Most Important Number: LIBOR Transition](#), have shown that the spread between LIBOR and rates similar to SOFR varies over time, averaging 36 bps and spiking to over 460 bps during the 2008 financial crisis.

Exhibit 1: Difference between 3M LIBOR and computed forward-looking SOFR and Treasury repo rate¹



Source: Thomson Reuters, Federal Reserve Bank of New York, Oliver Wyman analysis

¹ 3M SOFR and 3M compounded Treasury repo rate are calculated based on a geometric average of the overnight rate over a 90 day period on a forward looking basis. The Treasury repo rate is the volume-weighted mean rate of primary dealers’ overnight Treasury general collateral repo borrowing, as collected by the New York Fed through a daily survey

² Historical data for SOFR is only available from Aug. 2014 to Oct. 2017

These differences are key. It means that transitioning from LIBOR requires the industry to either replicate the credit and term features – or restructure products, bank funding, and internal processes. The industry and individual firms will have to determine whether SOFR is the best replacement rate or if another benchmark is more appropriate, for each product. For example, derivatives do not inherently depend on a term structure or credit spread and can be more readily transitioned to an overnight risk-free rate. On the other hand, loans and mortgages rely on both a term structure and the credit spread in LIBOR. In this case, the applicability of SOFR is unclear and will require more work to determine whether it can be used or if a new benchmark is needed. These are enormous tasks that are needed for LIBOR transition to be successful.

Now that SOFR exists, we urge industry groups and financial institutions to focus on identifying replacement rates for each product, including other rates (whether based on SOFR or a more appropriate benchmark) to address key details such as the term, credit, and

“stress” adjustments discussed above, and to evaluate the bank funding issues from pricing products away from LIBOR. In addition, new proposals (e.g. ICE’s new LIBOR methodology) need to be evaluated as they emerge.

A LARGE VOLUME OF NEW SOFR-BASED PRODUCT DEVELOPMENT CAN START NOW

New products that utilize SOFR need to be created, marketed, and sold to begin developing a non-LIBOR-based market. Using SOFR will reduce the size of the LIBOR-based portfolio that needs to be transitioned, as well as avoiding the potential risk of selling LIBOR-based products with the knowledge that LIBOR will be discontinued.

However, the volume of new products that will need to go through the (often lengthy) review and approval process may strain resources. This process will include educating clients ranging from retail customers to sophisticated institutional clients on the new rates and products. In addition, given the relatively small amount of historical data available on SOFR, the required updates to internal risk and pricing models will be complex.

THE TRANSITION AWAY FROM LIBOR HAS TO PICK UP SPEED

SOFR publication is a big step forward. However, there remains a host of uncertainties in scenario outcomes, e.g. what rate or rates will be used as the replacement for LIBOR for different products. Regardless, institutions are faced with a large and complex transition and should begin working on “no regrets” actions now.

These “no regrets” actions include building an inventory of exposures to LIBOR and a holistic view of impact on clients. Firms should begin identifying, on a product-by-product basis, whether SOFR, a SOFR-based rate, or a different reference rate is most appropriate to use. Early mobilization will provide the opportunity to get ahead of risks and minimize the impact and cost of transitioning away from LIBOR. In any case, firms should take steps to reduce the amount of new LIBOR contracts going forward.

Senior executives need to be considering the questions, “**What impact would a transition away from LIBOR have on our firm and our clients?**”, “**How can we utilize SOFR going forward?**”, and “**What should we be doing now to minimize risks and impact?**” There is now even more urgency to focusing on the transition away from LIBOR.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS

+1 212 541 8100

EMEA

+44 20 7333 8333

ASIA PACIFIC

+65 6510 9700

Contact

libor@oliverwyman.com

www.libortransition.com

www.oliverwyman.com

Copyright © 2018 Oliver Wyman

All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman.