ICAEW KNOW-HOW
FINANCIAL SERVICES FACULTY

10 QUESTIONS CORPORATES SHOULD BE ASKING ABOUT LIBOR TRANSITION

HELPSHEET

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The London Inter-Bank Offered Rate (Libor) has been the most widely used interest rate benchmark in financial markets and the daily published rates are referenced in an estimated total of around US$400 trillion of financial contracts, including loans, mortgages, bonds, securitised products and derivatives. The transition from Libor to the alternative reference rates (RFRs) is essential to strengthen the global financial system and with the end-2021 Libor cessation date firmly held; a significant effort is required to effect this change.

Given the impact is felt by not only financial services organisations but also the corporate community. ICAEW's Financial Services Faculty highlights 10 questions corporates can ask to build a robust conversation around how your firm is addressing readiness for Libor Transition

1. Has your firm identified where your organisation has exposure to Libor?

Libor is intended to reflect the borrowing cost for an international bank at different terms and in five major currencies. However, as a benchmark interest rate its use has expanded, even to some unexpected areas beyond financial agreements (borrowing facilities and derivatives). Other potential areas of exposure could include bond issuances, commercial agreements with customers and suppliers, inter-company funding, lease agreements for property and equipment, in models to determine valuations and impairment calculations as well as accounting and other key systems.

- ❑ All organisations should first and foremost do an inventory and quantification exercise to understand their Libor exposures. This is a critical step to begin the transition of your Libor exposure to alternative rates before cessation of Libor (expected by the end of 2021). Re-coding and repapering will follow this.

2. What are the key challenges for your organisation as a result of the transition? How do you plan to address them?

Corporates have some key challenges that need to be addressed early on.

- ❑ Libor is a forward-looking rate whereby the interest rate is set at the beginning of the interest period which determines payment at the end of the period, providing certainty of payments. The alternative rates are backward looking and will therefore determine the interest payment based on daily compounding (expected in the UK market) or simple averaging (currently gaining traction in the US market). Therefore, corporates will only know their final interest payment at the end of the period.

  Term rates are being developed for SONIA (alternative rate to Sterling Libor) by the end of 2020 and for SOFR (alternative rate to USD Libor) by the end of 2021.
- ❑ Whilst contractual fall-backs to the Libor rate for legacy derivative products have been defined by ISDA and will be executed through a market-wide protocol due to launch soon; cash products fall-back language is still under discussion. Corporates will need to be

cognisant of any basis generated by different fall-backs between their cash borrowings and derivative hedges. The ISDA protocol however does allow you to adhere and later exclude derivative trades with bi-lateral agreement of adhering parties.

- ❑ Changes to systems may be required to deal with the new rates. Corporates should be performing an impact assessment over their treasury systems and processes to prepare for alternative rates whether those be overnight or term.
- ❑ Bonds issued by firms include Libor as a reference rate. Changing bond contracts is a complex and time-consuming process given the number of bond-holders involved who would need to give consent to economic changes.
- ❑ There could be economic transfer value associated with the transition of legacy Libor contracts maturing beyond 2021. Libor and the alternative rates are not the same; Libor as well as being forward looking includes a term bank credit risk component that alternative rates like SONIA do not. Even the alternative rates by jurisdiction differ to each-other; some are secured (SOFR) and others unsecured (SONIA). Corporates should be engaging with their banks to understand the methodology that would be used either in a legacy contract conversion to alternative rates prior to the end of 2021 or in updating the fall-backs in these contracts.
- ❑ Time is tight for all firms. Whilst all firms have been rightly distracted by the impacts of Covid-19 to their businesses the FCA has made it clear that they do not plan to extend the end of December 2021 timeline for the expected cessation of Libor.

3. Will a term rate be available for the alternative rate? Should you look to use this?

A SONIA term rate is expected by the end of 2020. However, the UK authorities have made clear their preference for the market adopt a broad-based transition to SONIA compounded in arrears, with use of a term rate being limited. They have said that smaller corporates for whom simplicity and/or payment certainty is a key factor may wish to consider alternative rates to SONIA compounding in arrears.

A SOFR term rate is not expected until the second half of 2021 and therefore cannot be relied upon in the US market for transition.

4. How are you planning to deal with Libor exposures in different currencies?

Libor is heavily used because it covers five major currencies at seven different maturity terms, but all under one convention. However, the approaches taken internationally are not consistent with the configuration or timing of replacement rates and is likely to cause basis risk across currencies.

- ❑ How is your organisation approaching the Libor exposures across different currencies?

5. Has your organisation looked at how it will approach key counterparties? And when?

Have you reached out to your banks and key counterparties in relation to libor transition?

- ❑ What are your organisation’s plans re communication, potential value transfer and staff training?
- ❑ Given the end of 2021 is drawing close it seems that proactive organisations are reaching out now to educate themselves and start the dialogue on contract repapering. The ISDA protocol is expected to further accelerate market activity.

6. How are you communicating the impact of Libor reform to investors, where material?

Investor understanding of the material risks impacting an organisation may change as a result of Libor reform. Additionally, they will want to understand whether there is likely to be a material impact on their investments, or change to the management of interest rate risk by the organisation, as a result of Libor reform.

- ❑ Have you ensured that your organisation has clearly explained to investors how Libor reform could impact your organisation and how those risks or challenges will be mitigated?

Refer to our separate “10 Questions” with respect to “Accounting and Disclosures” for further information.

7. What are your organisation’s plans to use the new replacement rates in place of Libor?

Some organisations are still entering into Libor in new financial and commercial arrangements despite the December 2021 end-date. This may mean that the necessary systems and processes are not able to deal with the specific requirements of the new RFR replacement rates or other fall-back arrangements.

- ❑ Has your organisation put in place appropriate fall-back arrangements and made the necessary changes to systems and processes to allow it to transition contractual arrangements to new RFR rates where appropriate?

8. Have we considered our remediation strategy for legacy contracts?

The UK regulator has stated its preference for the market to convert contracts prior to the end of 2021 and only rely on fall-backs as a ‘safety-belt’.

- ❑ Has your organisation considered its transition strategy by agreement type of whether you plan to convert your legacy contracts into a replacement rate prior to 2021? Rely on a fall-back which will be triggered by a cessation or pre-cessation event? Treat the contract as ‘tough legacy’?

9. Are we keeping up to date and engaging in the relevant industry solutions?

Proactive organisations are engaging with the industry consultations and feeding into developing solutions. You can keep track of these through your relevant industry body or by contacting us.

https://www.treasurers.org/hub/technical/libor/act

10. How is your organisation approaching the accounting and tax impacts of Libor transition?

(a) Accounting

Hedge accounting for example, allows a more forgiving accounting treatment where organisations use an interest rate derivative to offset interest rate changes, if certain criteria are met. The uncertainty around the future of Libor places these key tests under enormous pressure. The IASB has granted relief for organisations to continue to use the hedge accounting rules in these circumstances, despite the uncertainty and performance of the usual tests.

- ❑ What is your organisation's approach to hedge accounting and Libor transition?

(b) Tax

In some cases, Libor transition and the change to an alternative reference rate could be a taxable event. For example, gains or losses could be realised if a debt obligation is exchanged or significantly modified.

- ❑ Your organisation should review contractual terms and discuss with professional advisors to understand potential tax implications.

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