Newsflash

Preparing for the discontinuation of LIBOR

On 19 September 2018, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) wrote to the CEOs of large banks and insurance companies in relation to the likely discontinuation of the London Interbank Offered Rate (LIBOR) and the transition to alternative reference rates by the end of 2021.

The purpose of the letter is to seek assurance that senior managers and boards understand the risks associated with this transition and that they are taking appropriate actions now to prepare for it.

The PRA and FCA have asked firms to provide a response by 14 December 2018, covering the following areas, which should be approved by the board:

- Summary of the firm's assessment of key risks relating to LIBOR discontinuation and details of plans for mitigating these risks;
- Assessment and plans should cover a wide range of scenarios and impacts;
- Quantification of the firm's exposures to LIBOR; and
- Details of Senior Manager(s) within the firm who will oversee the provision of the response to the letter and the implementation of the transition plans.

Whilst the letter is reported to have been sent to only the largest banks and insurers, the PRA encourages all firms who currently rely on LIBOR to read and reflect on it.

Why is LIBOR being discontinued?

LIBOR is the average rate that leading banks in London would be prepared to offer to other banks looking to borrow from them on an unsecured basis for a range of terms e.g. 3 months or 6 months.

LIBOR is the reference rate underlying many derivative contracts, securitisations and loans. It is also used extensively in risk, valuation and commercial contracts within insurance companies.

Following the financial crisis, banks have moved away from unsecured term borrowing in the inter-bank market. The reduced level of activity has prompted questions around the sustainability of LIBOR as a benchmark rate.

The Financial Policy Committee's (FPC) June 2018 Financial Stability Report refers to a judgement made by the FPC in March 2017 that *"continued reliance of financial markets on term LIBOR benchmarks created a risk to financial stability"*. The report provides some important statistics underlying this judgement:

- In 2017, UK banks took on average £187m of three-month sterling deposits each day (and £87m of six-month deposits).
- This compares to over £30 trillion of financial contracts that are linked to three and six-month LIBOR.[1]

The report goes on to say that *"The medium-term risks can be reduced only through a substantial and lasting transition away from reliance on Libor."*

[1] The FPC report states that these are primarily interest rate swaps, interest rate futures, cross-currency basis swaps, syndicated loans and floating rate notes.

So what will replace LIBOR?

The Sterling Risk-Free References Working Group, established in 2015 to implement the Financial Stability Board's (FSB) recommendation to develop alternative risk-free rates in the UK (for use instead of LIBOR-related reference rates), has identified the Sterling Overnight Index Average (SONIA) as its preference.

SONIA represents the overnight interest rate at which banks lend to each other on an unsecured basis. It is based on actual transactions.

Whilst LIBOR and SONIA both represent borrowing on an unsecured basis, because SONIA is an overnight rate (rather than e.g. a 3 or 6 month rate) it can be argued to be much closer to a measure of the risk-free rate. Indeed the Solvency II risk-free rate adjusts the LIBOR swap curve in an attempt to remove the credit risk element that comes from lending to banks on a term basis.

So why are we still relying on LIBOR in the UK? One reason is that, to date, there have been concerns over whether the SONIA market is sufficiently deep, liquid and transparent to be relied upon. However the SONIA benchmark has been strengthened in this area by the reforms implemented by the Bank of England on 23 April 2018:

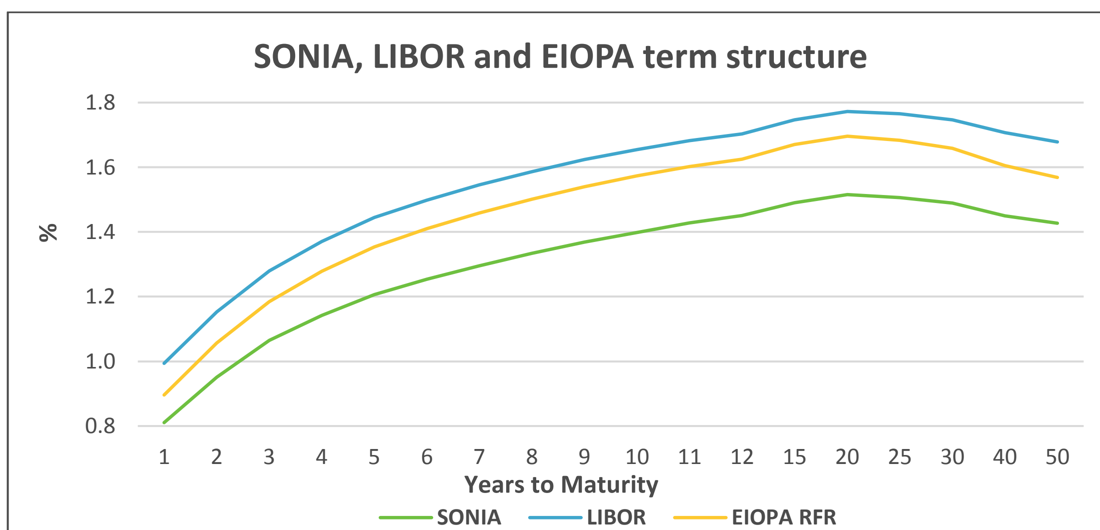
- The Bank of England is now the administrator (including the calculation and publication of SONIA), with the publication of the methodology used to ensure transparency on how the rates are derived;
- The coverage of SONIA being extended to include overnight unsecured transactions negotiated bilaterally as well as those arranged via brokers, to increase the volumes of trades being taken into account and hence improve the liquidity of SONIA;
- The averaging methodology for calculating SONIA changing to a volume-weighted trimmed mean; and
- The publication of SONIA moving to 09:00 on the business day following that to which the rate pertains – this delayed publication allows the bank to account for a higher volume of activity.

Consequently, the transition away from LIBOR to SONIA has been gaining momentum.

Comparison of different interest rate curves

The graph below compares the SONIA swap curve, the LIBOR swap curve and the Solvency II risk-free rate curve (which is prescribed by the European Insurance and Occupational Pensions Authority (EIOPA)).

The EIOPA curve is based on the LIBOR swap curve (where LIBOR is based on a 6 month term) but allowing for a Credit Risk Adjustment (CRA), which was -10bps as at 28/09/2018. As noted above, the CRA is intended to remove the element of credit risk from the LIBOR swap curve.



Source: Bloomberg, EIOPA (as at 28/09/2018)

Note: The LIBOR and SONIA swap curves show the fixed rate that can be achieved by entering into an x-year interest rate swap, where the floating leg of the swap references SONIA or 6 month LIBOR.

We can see from the chart, and as expected, that SONIA is typically lower than LIBOR at all maturities. The difference between the two rates is c25bps at the 25 year point (as at 28 September 2018).

What are the potential implications of transitioning from LIBOR to SONIA?

LIBOR is a significant reference rate for insurance companies. It forms the basis of the discount curve used for valuing liabilities, it is used to determine payments on interest rate derivatives and it is embedded in a variety of assets and commercial contracts.

So the implications of transitioning from LIBOR to SONIA are far-reaching and will affect insurers in a number of ways. Given the relatively short timescales – both for responding to the PRA/FCA letter and until 2021 – firms will need to prioritise the areas that are most significant for them. We explore some of these below.

Area	Considerations for firms
Entering into new contracts that reference LIBOR or SONIA	• Where new contracts reference LIBOR, does the contract provide a 'fall-back option' in the event that LIBOR is discontinued? (Note that The International Swaps and Derivatives Association is currently consulting on fall-backs for derivative contracts) • Should new contracts reference SONIA rather than LIBOR? (And when to make this switch?) • New investments may also be impacted by a change in the reference rate, e.g. for floating rate notes and securitisations • Similar considerations may apply to reinsurance contracts, where a reference rate is needed to determine mark-to-market positions and hence collateral requirements
Renegotiating existing/legacy contracts	• What fall-back options are provided for in existing contracts? • Further to the above, to what extent do existing contracts need to be amended to allow for the future discontinuation of LIBOR? • Whether to replace existing LIBOR swaps with new SONIA swaps • When to engage with counterparties to begin any renegotiations • Similar considerations may apply to reinsurance contracts
Potential changes to Solvency II risk-curve	• Firms may want to consider the scenarios of both no change and a change to the Solvency II risk-free rate. (The letter from the PRA/FCA states that monitoring the LIBOR transition has been added as a topic to the EIOPA's general work on insurance risk-free reference rates) • There is no indication at present of whether there will be any changes, or what any changes might be – therefore firms will need to consider suitable scenarios to test. This may include consideration of changes to the Last Liquid Point • Liabilities valued under Matching Adjustment may be relatively unaffected, however other business lines will be impacted by a change to the risk-free rate curve (although the impact perhaps dampened where the Volatility Adjustment is applied) • The Solvency Capital Requirement and Risk Margin components of the balance sheet may also be impacted • For some firms, the Solvency II balance sheet impacts may be (partially) offset by changes to the Transitional Measure on Technical Provisions
Asset Liability Management ('ALM')	• Any difference between the Solvency II risk-free rate and the reference rate underlying assets and hedging instruments could give rise to basis risk for the firm • If the Solvency II risk-free rate curve is revised to allow for the transition away from LIBOR, then existing hedges may need to be rebalanced
Other considerations	• Any dependencies of product pricing on the risk-free rate • Modelling a new basis risk for Internal Model firms – i.e. a different swap to gilt spread risk

So where next?

Andrew Bailey, the Chief Executive of the FCA, mentioned in his July 2018 speech that *“the discontinuation of LIBOR should not be considered a remote probability 'black swan' event. Firms should treat it is as something that will happen and which they must be prepared for”*.

So this is far from a theoretical exercise – change is coming.

For firms who received the letter from the PRA/FCA, the focus over the next couple of months will be to identify areas where their business may be impacted and formulate mitigation plans.

The letter should also serve as an indicator to other firms to start making preparations now.

As an initial step, we see merit in drawing together relevant experts and stakeholders from across your business and running workshops to begin the process of:

- Understanding your exposures to LIBOR;
- Identifying the different scenarios and risks that your firm might be exposed to; and
- Formulating your mitigation plans.

The impacts for firms will be wide-ranging, but those who start making preparations now will be best placed for a smooth transition when LIBOR is likely to be discontinued in 2021.

Hymans Robertson has a wealth of experience in Investment/ALM, Risk & Capital Management and Reinsurance. We would be delighted to support you in preparing for the transition away from LIBOR.

If you would like to discuss with one of our specialists, please get in touch.

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