LIBOR transition in 2021

"It's time to develop a strategy for the treatment of LIBOR-referencing derivatives in 2021 and beyond.

pwc

December 2020

LIBOR transition in 2021

Why it is time to prepare now

The external timeline of the LIBOR transition marks the starting point for any transition strategy for derivative instruments

- **23th Oct 2020** – LIBOR Fallbacks Supplement to the 2006 ISDA Definitions and the ISDA 2020 LIBOR Fallbacks Protocol are published
- **25th Jan 2021** – ISDA Supplement takes effect
- **Q1 2021** – Expected LIBOR pre-cessation trigger event to fix the 5 yr. median credit spread adjustment
- **Jan 2022** – LIBOR Fallbacks have to be used for non-transitioned trades
- **Jul 2023** – Consulted USD LIBOR cessation

The time is now for **defining a suitable derivative transition strategy** that outlines the measures to be taken until LIBOR cessation, commonly expected in January 2022 (potentially except for the currently consulted USD LIBOR tenors O/N, 1M, 3M, 6M and 12M). Although there is no regulatory requirement to **actively transition** existing LIBOR exposure to the new risk-free rate (RFR) world, an active transition is promoted by regulators and it certainly facilitates the handling of trades from 2022 onwards. Derivatives that are not transitioned actively will use the **LIBOR fallbacks** in case of institutes' adherence to the ISDA fallback protocol from 2022 onwards. This is the most prominent example of a **passive transition**.

A transition strategy must fulfill all constraints that may arise from internal timelines, risk management or regulatory reporting requirements. These constraints have to be identified as early as possible to get a complete picture and a strategy that fits institution wide.

All possible transition strategies may arise from a hand full of distinct components

For an all-embracing assessment of possible transition strategies, it is very useful to first define a **few transition components** of which all possible strategies consist**.** The most obvious are the **active and the passive transition** of LIBOR trades. It is also a possible solution to outsource certain tasks of the active transition to other banks. This includes analyzing the bank's portfolio, identifying a suitable transition, managing the basis actively and executing a pricing call with all related counterparties. Such banks are called Basis Risk Manager Bank (BRMB).

Strategies result either from applying a **single transition component** to the entire portfolio or **from combining several components** to distinct portfolio parts or individual time phases. Identify the institution's best strategy, a **qualitative or quantitative assessment** of the strategies is key. The definition and especially the **weighing of the assessment dimensions** against each other is institution specific.

	Active	Passive	BRMB	Hybrid
Operational Capacity	◔	◕	●	◕
NPAs	◔	◕	◔	◑
Transaction Costs	◑	●	◔	◑
Trade Interconnections	◑	●	◕	◕
Tenor-Basis Risk	◑	◕	●	◕
Certainty over trade lifecycle	●	◔	◕	◕
Information Disclosure	●	●	○	●
Outside option	●	○	◑	●

Legend: Negative assessment: ○ Neutral assessment: ◑ Positive assessment: ●

The assessment of the various strategies will be a combination of the **pros and cons of a single transition component**. The assessment of the building blocks harmonizes and facilitates the strategy assessment.

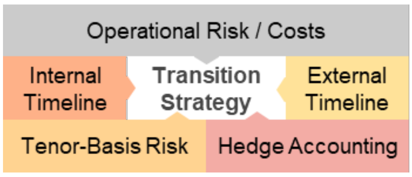
> "Keeping the focus on a few transition components helps not to lose sight of the bigger picture of choosing various transition strategies

The **best transition strategy will most likely be a hybrid one.** This means that the institution will not use either an active or passive transition for complete portfolio but a combination. Drawbacks like transaction costs in an active transition or introduction of uncertainty throughout the whole trade lifecycle in a passive transition, can be compensated by advantages of other transition parts.

After the best strategy is identified, the question arises which trades should be approached first.

The selection of trades to transition using the identified strategy can follow a waterfall approach

Putting the strategy into practice, both the **external timeline** and **internal timeline** including **NPA processes and system releases** have to be considered. To mitigate and limit **operational risk**, it is advised to start with trades which transition is "**cheap, simple and safe**".



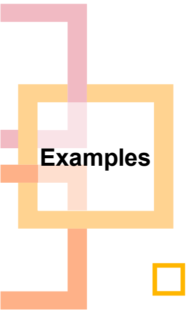
Cheap: Volatility and the riskiness of the portfolio determine the transition price

Transaction costs will not only be determined by the **volatility of the LIBOR-RFR basis**, but also by the portfolio of trades that is in scope of the transition with a counterparty. A **delta neutral set will be cheaper** to transition, since no further hedging is required. Last but not least, **building up liquidity will decrease transaction costs** as time goes by.

Simple: The portfolio is the basis from which nearly all constraints arise, especially the simplicity of the transition

Simplicity means a single trade is considered alone and it is not used for **hedge accounting purposes**. To categorize trades, a thorough analysis of the portfolio has to be performed initially. This includes the identification of links to the transition components, and the case when the trades are actually transitioned.

A general **portfolio categorization** gives a good first indication of the **complexity of the trade's operating environment**. Based on this, a **detailed analysis for each category** is needed, in order to **identify any restriction** that comes with the relevant category. In the following, a few examples are considered:



ALM Swaps

These are free standing positions, which are used to control for risks in various maturity buckets. As such, they act through the direction of their cashflows and may be transitioned without restrictions.

Back-to-Back trades

When hedging risks from the loan customer side to the swap market side, a hedging gap will open as long as there is no fixed convention on the loan side. Such interconnections can generate additional restrictions.

Hedge Accounting

The transition shall preserve designated hedges. The safest way to do so is by transitioning the whole trade structure. This structure may be very complex and it may not even be possible to transition them at one.

A **reliable data quality** is of utter importance. An insufficient quality hinders analysis and creates extra operational expenses for corrections which may even be P&L relevant.

Safe: The ex-ante estimation of the tenor-basis risks indicates if a transition is safe or a limit breach may occur

Safety means that the next subset of trades that will be transitioned does not lead to a significant increase in the **tenor-basis risks**. For a reliable estimation, the risk department has to calculate the effect of a partial portfolio transition.

From the pre-cessation trigger event onwards, the LIBOR and RFR + Spread are expected to move highly correlated, although they arise from very different concepts. If this market expectation is met, this will have an **effect on the risk models**, which mostly rely on historically market data and thus **implicitly exclude instantaneous structural breaks**. This must be addressed together with the risk department to get a **reliable tenor-basis risk estimation** or to be aware of a possible **over- or underestimation of the basis risk**.

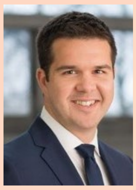
How you can benefit from us

We are currently supporting various banks and asset managers in defining and setting up a suitable transition strategy	We have proven and standardized assessment frameworks and transition toolkits to individually evaluate and execute the best suited transition	We are in close cooperation with industry associations such as ISDA, DRV or LMA, to always take the latest developments into account

Reach out to us to better understand the implications for your institution to develop a tailored LIBOR transition strategy

PwC Contacts

Dirk Stemmer
Partner
Phone: +49 211 981-4264
Mobile: +49 160 93403524
dirk.stemmer@pwc.com



Heiko Christmann
Senior Manager
Phone: +49 211 981-5402
Mobile: +49 160 97991360
heiko.christmann@pwc.com

Carsten Olbrich
Manager
Phone: +49 711 25034-1686
Mobile: +49 170 97811986
carsten.olbrich@pwc.com

Kristin Stein
Manager
Phone: +49 211 981-7658
Mobile: +49 151 17585500
kristin.stein@pwc.com

Dr. Daniel Ullmann
Senior Associate
Phone: +49 69 9585-1739
Mobile: +49 151 28494782
daniel.ullmann@pwc.com