Libor transition is progressing: the next steps

UniCredit Research Webcast

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Banking that matters. UniCredit Corporate & Investment Banking

Libor transition in a nutshell

Why move away from Libor (the pandemic has not affected or delayed this decision)

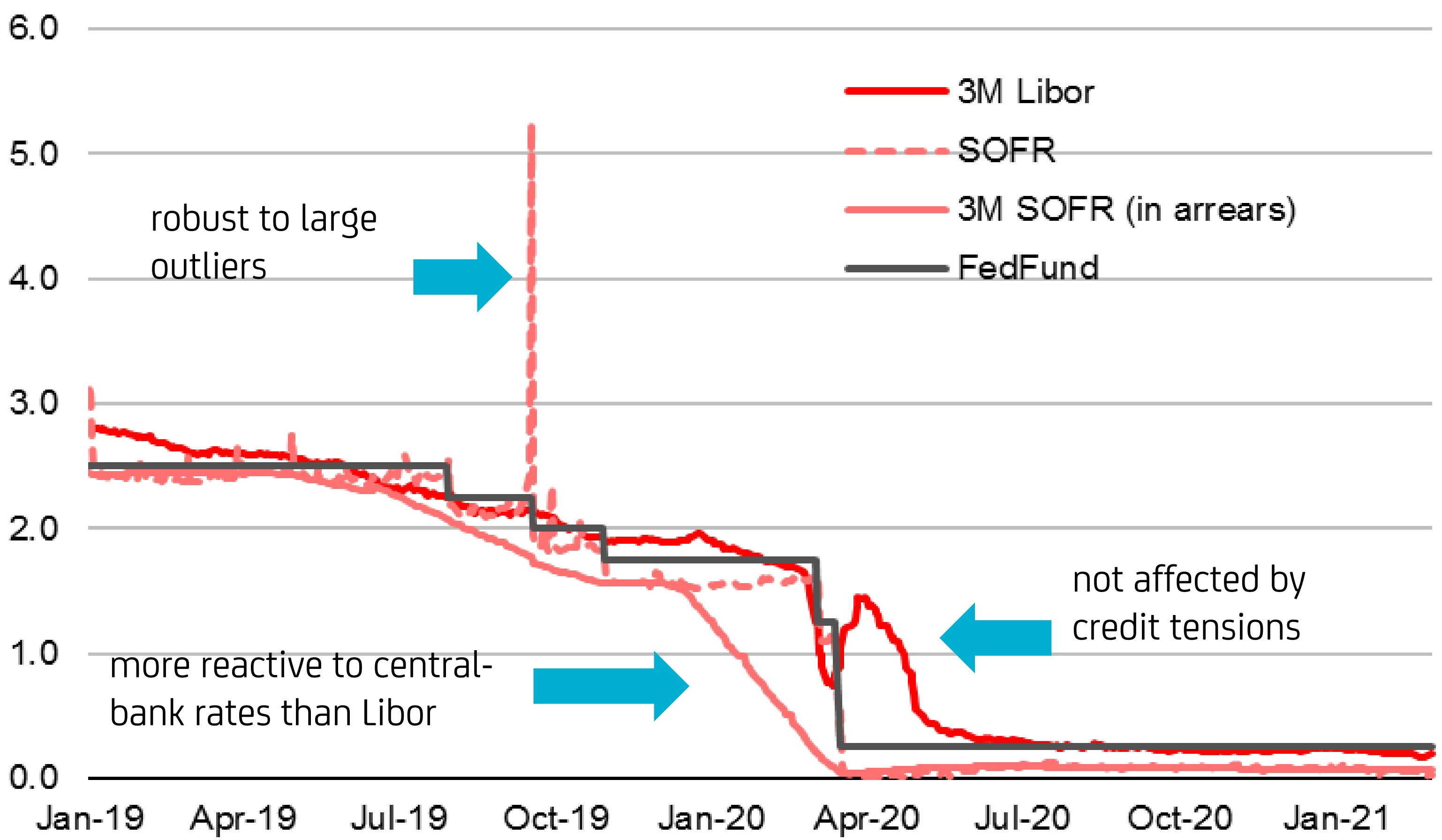
Risk-free rates as a replacement for Libor

	From	To ISDA Fallback
	LIBOR	**Alternative Reference Rates (ARRs)**
		+ Credit Spread Adj.
	+ Commercial Spread	+ Commercial Spread
Approach	Forward-looking	Backward-looking
Fixing	In Advance	In Arrears
Rate type	Simple	Compounded average

Luckily we do not need to calculate the fallback: Bloomberg does it already

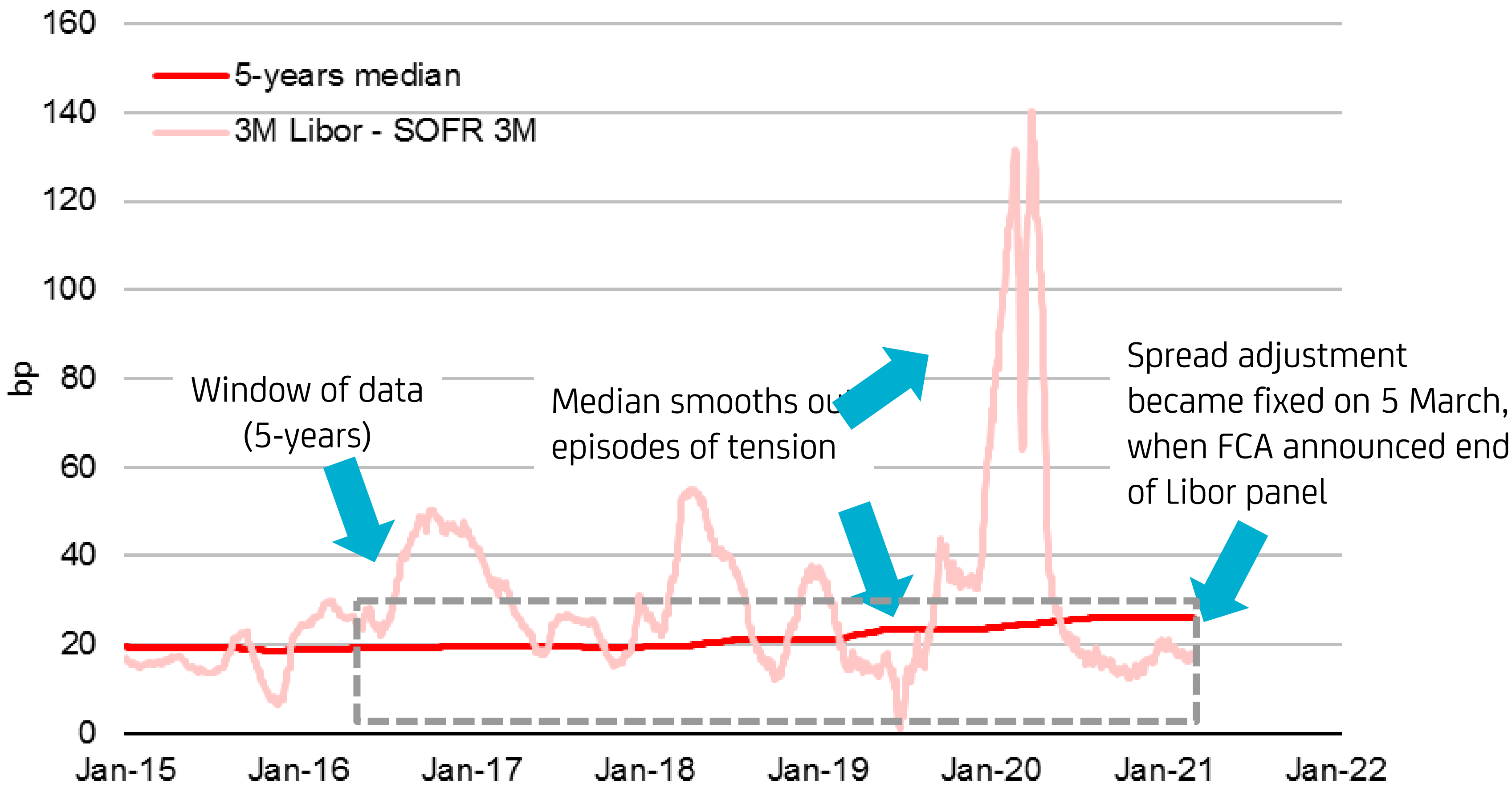
Source: UniCredit Research

How do RFR in arrears behave in practice?



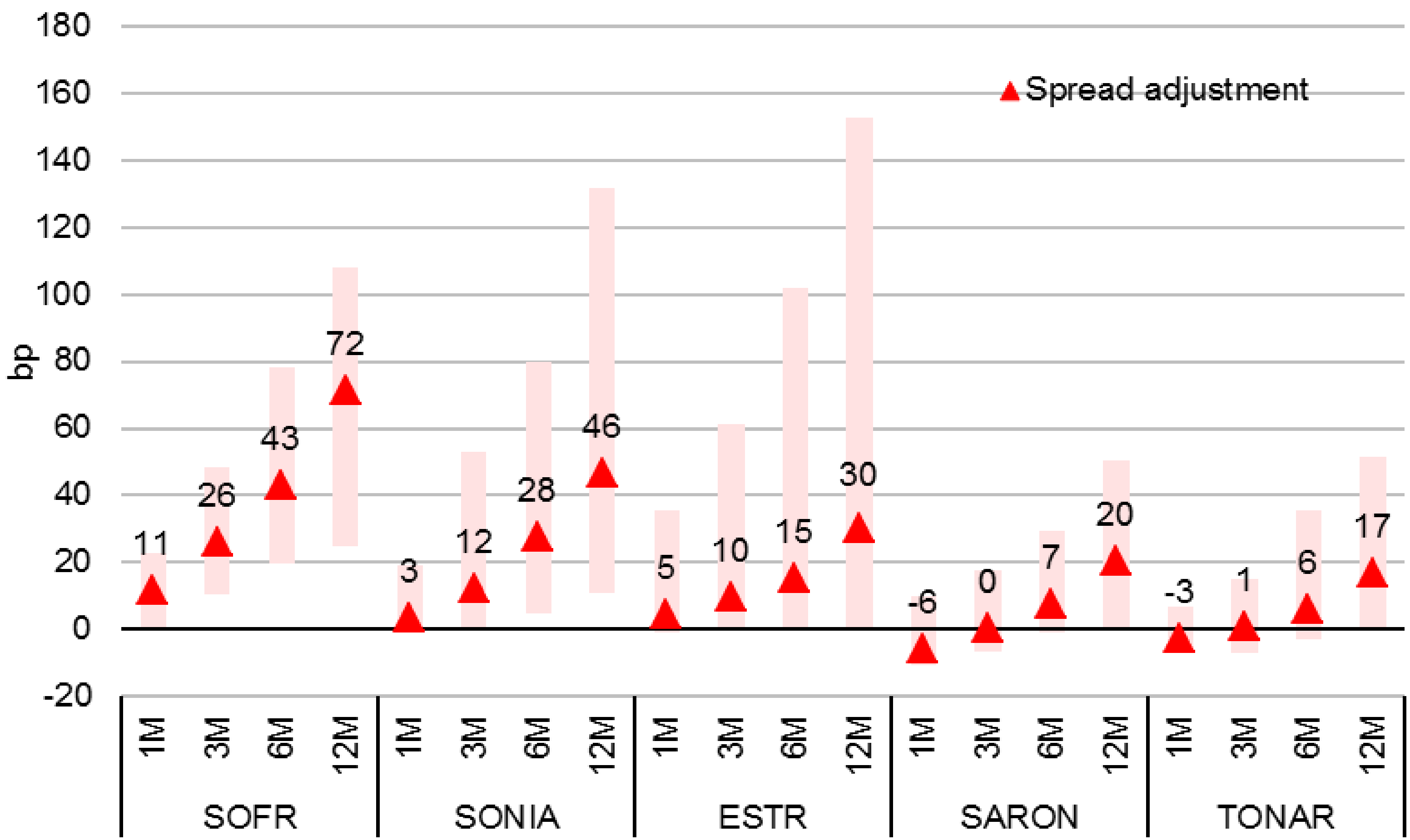
Source: Bloomberg, UniCredit Research

Spread adjustment in practice : the 3M USD



Source: Bloomberg, UniCredit Research

Spread adjustment is now fixed



Vertical bars show the 5-95 percentile of Libor-RFR for each tenor and currency (Jan 2010-Jun 2021)

Source: Bloomberg, UniCredit Research

Libor transition: recent steps

Date	Event	Implications
25 Jan 21	**New ISDA protocol comes into effect**	New derivative contracts will contain fallback language referencing RFR plus a spread. Fallback language will also take effect in outstanding covered ISDA contracts where both parties have signed the protocol
5 Mar 21	**FCA announces end dates for Libor**	FCA announces future cessation or loss of representativeness of the 35 Libor settings published by ICE and the dates when the LIBOR panels will end
8 Jun 21	**SOFR First**	Interdealer trading of USD linear derivatives (outright swaps, swap spreads and curve trades; basis swaps and FRAs are not involved) will move to SOFR starting on 26 July.
24 Jun 21	**FCA lunches consultation on synthetic Libor**	Proposal to require Libor admin. to change methodology to a synthetic LIBOR calculated using a term rate plus the ISDA spread adjustment. The consultation applies to 1M, 3M & 6M for yen and sterling

The reform is in constant evolution

Source: FCA, ARRC, BoE, Fed, UniCredit Research

The end-of-Libor calendar

	JPY	GBP	USD	EUR & CHF
Overnight	31 Dec 21	31 Dec 21	30 Jun 23	31 Dec 21
1W, 2M	31 Dec 21	31 Dec 21	31 Dec 21	
1M, 3M and 6M	Possible publication on synthetic basis...			
	...for one year starting from 1 Jan 22	...for a further period starting from 1 Jan 22	...for a further period starting from 1 Jul 23	
12M	31 Dec 21	31 Dec 21	30 Jun 23	

Synthetic Libor is only for the purpose of managing legacy contracts

No new business referencing Libor from 1 January 2022

Source: FCA, UniCredit Research

How legacy contracts are operated once Libor ends?

Legacy contracts: how to manage contracts referencing Libor that will expire after the cessation of Libor?

Derivatives (exchange-traded, OTC) → ISDA protocol/LCH

Tough legacy
(bonds, loans, cross-border contracts) →

- USD Libor panel will stay in place until June 2023 to favor run-off (no new business will reference it)
- Synthetic Libor (GBP, JPY)
- Ah-hoc legislation

Active management by counterparties strongly advised by regulators:
Firms should proactively remove Libor dependencies from their contracts before the end of 2021 to reduce uncertainty and risk

Source: FCA, ARRC, BoE, Fed, UniCredit Research

How new contracts will work

Overnight risk-free rates very likely to be the new standard

Compounding in arrears or backward-looking (average of past periods)
Term rates would be the preferred option for some products (e.g. retail products, trade finance)
Term rates are "under construction" (ICE launched 1M, 3M 6M & 12M SONIA term rates), robust trading activity will be important

Need to take bank funding cost into account

Different products may require different conventions for averaging RFR (simple vs. compounding, lookback etc.). This may complicate hedging

Possible alternatives (ICE bank yield index, for example)
Mind the gap: RFR already have a growing derivative market

Source: FCA, BoE, Fed, national working groups on RFR, UniCredit Research

Euribor is here to stay – but fallback language is key

The Euribor is administered by EMMI and has been declared compliant with the BMR. Euribor is here to stay

While there are no plans to remove this benchmark, it is crucial to insert robust fallback language into existing and future contacts that can address a permanent discontinuation of the benchmark

- Clear definition of trigger events
- Clear definition of the fallback (€str recommended)

On 11 May 2021, the working group recommended trigger events and Euribor fallback rates for a number of products. As a general rule: use forward-looking term rates if available and backward-looking options otherwise. Please see the full report here.

Source: FCA, ARRC, BoE, Fed, UniCredit Research

Conclusions

Libor transition is advancing. Dates when Libor panel will end have been announced for all tenors and currencies

Synthetic Libor may help an orderly transition, new business needs to move away from Libor

Addressing legacy contracts will be important; the golden rule is to seek active transition whenever possible

There are no plans to remove Euribor, but it’s crucial to insert robust fallback language in contracts

The reform is in constant evolution, it is important to keep informed

Source: UniCredit Research

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