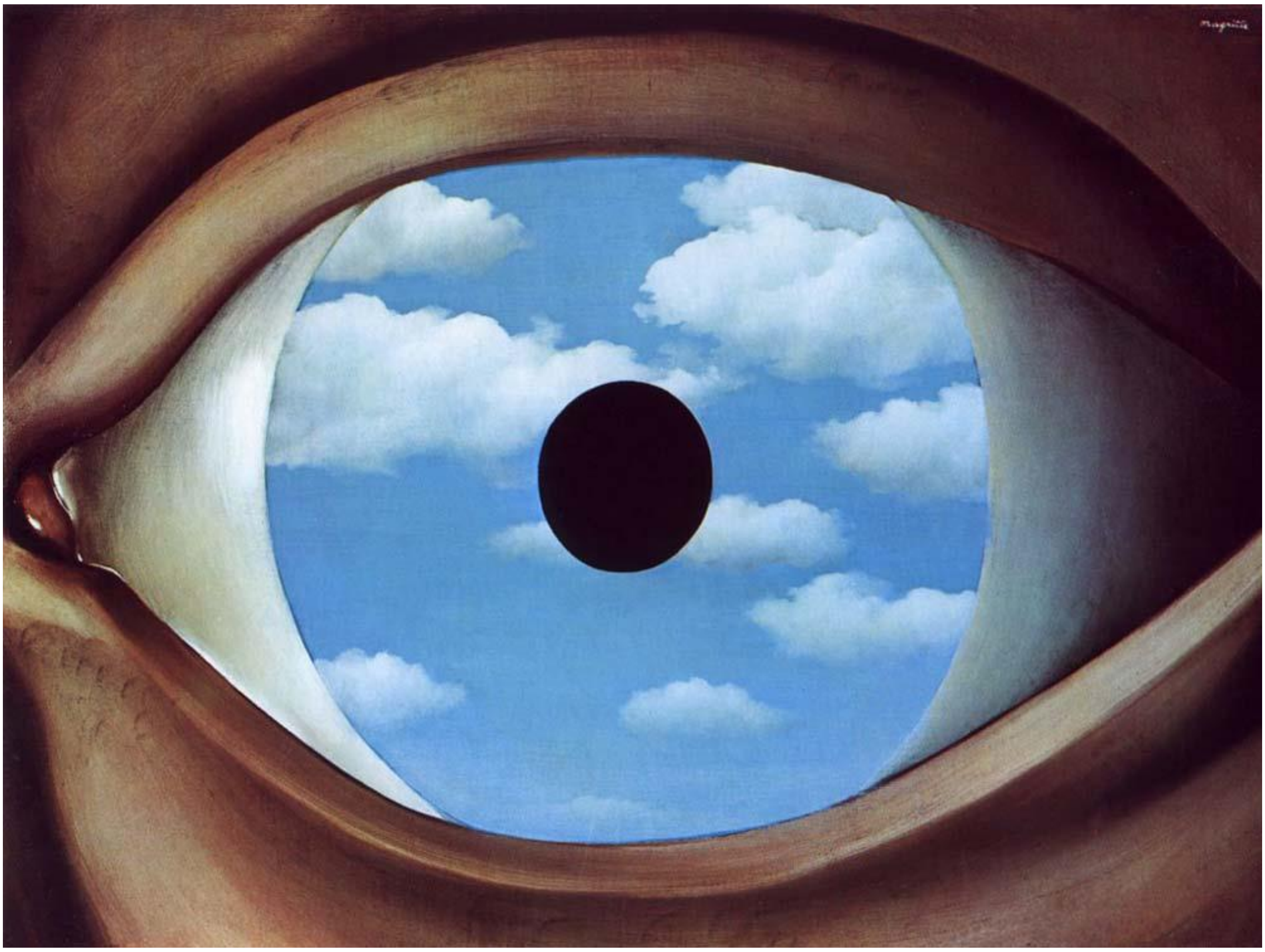

IBOR Reform

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Glossary

€STR	Euro Short-Term Rate
ALM	Asset and Liability Management
ARR	Alternative Reference Rate
BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
CCP	Central Counterparty Clearing
CLOB	Central Limit Order Book
CSA	Credit Support Annex
ECB	European Central Bank
FASB	Financial Accounting Standards Board
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FRN	Floating Rate Note
FSB	Financial Stability Board
HQLA	High Quality Liquid Asset
IASB	International Accounting Standards Board
IBOR	Interbank Offered Rate
ICMA	International Capital Market Association
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
OTC	Over the counter
PV	Present Value
RFR	Risk Free Rate
SEC	U.S. Securities and Exchange Commission
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Index Average
TLP	Term Liquidity Premium
TONAR	Tokyo Overnight Average Rate

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Overview

In this paper, Solum will review the current state of the IBOR transition, highlighting a number of the major obstacles that the market is grappling with and debating some of the potential solutions for a successful transition.

Due to the limited volume of underlying transactions, panel banks must rely too heavily on expert judgement in their current LIBOR submissions, raising concerns over transparency and robustness in the construction of the benchmark. At the same time, individual panel banks have become concerned by the reputational and litigation risk surrounding making submissions. The regulators have made it no secret that they believe IBORs to be unrepresentative.

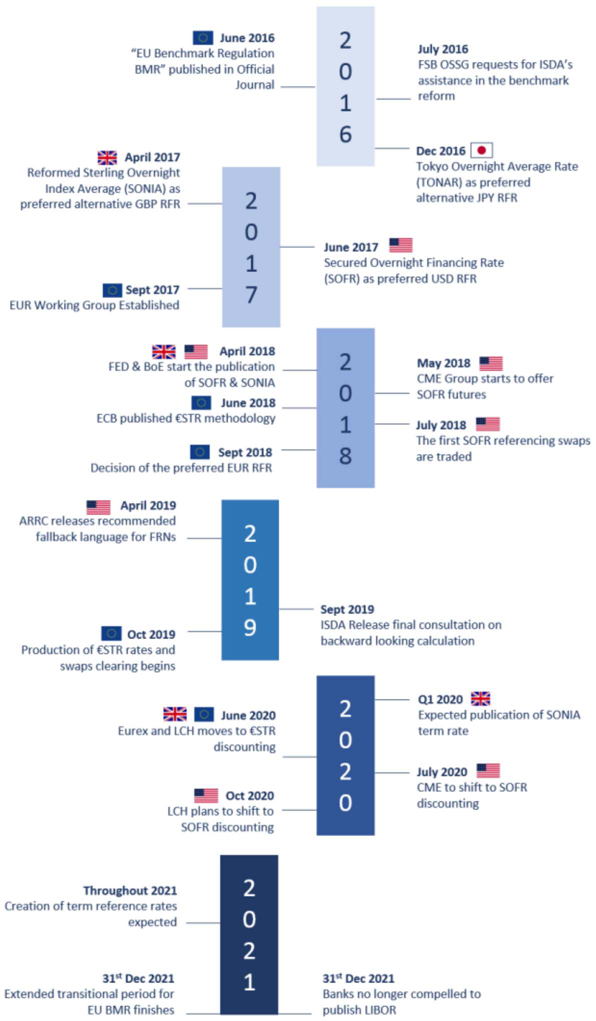
The global benchmark reform process has been underway since 2009 under the auspices of industry bodies, in conjunction with regional working groups sponsored by regulators and the Financial Stability Board (**FSB**). As part of this reform, the need to replace most of the existing and widely used benchmarks became a regulatory imperative.

As several banks had already withdrawn from the LIBOR panel, the prospect of further withdrawals raised the possibility of widespread disruption if banks stopped submitting altogether. To avert this outcome and buy time for an orderly transition to alternative reference rates, in July 2017, the FCA[1] intervened and compelled the remaining panel banks to continue submitting, but only until the end of 2021.

In July 2019, the FCA announced that it would "*not hesitate to make the representativeness judgments that it is required, under law, to make*".[2] The regulatory view is clear: "*LIBOR is not representative and will not be authorised under the benchmark regulations*".[3]

The emergence of a potential end date for LIBOR certainly increased transition planning activity. However, progress in actual migration to new alternative reference rates (**ARRs**) has been slow for a number of reasons, not least due to the complexity of the issues involved in replacing a LIBOR reference rate that is pervasive across differing asset classes and multiple jurisdictions. Inertia from market participants awaiting "ready-to-use" solutions to some of the operational and valuation issues arising for such a mammoth enterprise has also not helped.

Figure 1: Timeline



[1] FCA: The Future of libor
[2] LIBOR: preparing for the end
[3] LIBOR: preparing for the end

Over the past year, there has been a marked hardening of the regulatory position. The FCA's September 2018 'Dear CEO' letter[4] was designed to ensure transition planning was elevated to a Board level action plan. Both the Federal Reserve Board (**FED**) and the Bank of England (**BoE**) have stated that supervisory review of transition planning would become part of their regular examination process. Increasing global regulatory co-ordination saw the European Central Bank (**ECB**) write its own 'Dear CEO' letter also requiring a detailed action plan.[5]

Although there is no definitive end date for LIBOR, the objective of global regulators is to minimise the risks of market disruption associated with LIBOR discontinuation.

In July 2019, the U.S. Securities and Exchange Commission (**SEC**) confirmed that it was actively monitoring the extent to which market participants were identifying and addressing the risks of a discontinuation of LIBOR and a transition, to ensure the necessary remedial work would be completed in an orderly manner.[6]

Having identified the ARRs to be the chosen Risk-free rates (**RFR**s) (i.e. SONIA, €STR, SOFR), the regulators believe that the best transition plan is to migrate contracts that reference LIBOR to reference one of the alternative RFRs before any LIBOR cessation event.

However, the complexity of a transition to completely new rates in a short period of time, with a minimum of market disruption, is clearly a daunting task.

Fallback Provisions

The fallback mechanism incorporated into existing documentation is widely recognised as not fit for purpose in the event of a permanent cessation of LIBOR. In certain documentation ambiguities exist that would require interpretation and potentially difficult bilateral negotiations. In many cases the use of the existing fallback would change the economics of the contract potentially resulting in a value transfer between counterparties.

In 2016, the FSB's Official Sector Steering Group asked ISDA to define more robust fallback provisions for derivatives contracts referencing IBORs, which has led to a number of market consultations (the latest of which closes on 23rd October 2019) to address, in particular, associated value transfer.

A value transfer occurs when legacy transactions are transitioned from LIBOR to an RFR since RFRs do not contain the credit premium that is present in LIBOR. Market consultations seek to agree on a methodology to determine the adjustment spreads to be added to the relevant RFR in the fallback provisions to compensate for the missing credit premium and to minimise the value transfer caused by a transition to the RFR for legacy transactions.

In theory, the calculation of a term structure for the spread adjustment would completely eliminate the value transfer. Nevertheless, throughout the various consultations, the market has expressed its preference for a simpler and operationally less complex approach, which will involve the calculation of a single adjustment spread for each term IBOR, based upon observations of the historical spread between the relevant term IBOR and the compounded RFR over the same term. Once determined, the single adjustment spread may differ from the market implied forward spreads at the time of the migration, which may cause a valuation change.

However, once the methodology for determining the fixed spread is finalised, it is likely that a market repricing of the forward spread will occur and that the market implied forwards will

[4] FCA: Dear CEO letter transition from libor banks
[5] ECB: Dear CEO letter
[6] https://www.sec.gov/news/public-statement/libor-transition

converge to the historical spread value as the anticipated date of LIBOR discontinuation nears. Market repricing of the spread has resulted in periods of volatility especially in Q2 2018 which saw a marked spread widening most likely associated with the early exit of Libor positions from buy side firms. However, the effect of a more orderly market repricing can be observed in the SONIA/LIBOR spread following the release of the ISDA consultation in November 2018,[7] as illustrated in Figure 2 below.

Figure 2: 30-year 3-month GBP LIBOR vs. SONIA Spread

Source: Bloomberg

As more clarity emerged concerning the methodology market spreads fell sharply from around 25bps (in the 30-year tenor) converging towards the theoretical calculation of 12-17bps (depending on methodology chosen). Increasing market certainty around the methodology for calculating the adjustment spread has resulted in further market convergence over the course of 2019. Solum would expect to observe a further tightening in market spreads following the results of the next ISDA consultation, most likely in November 2019.

Solum notes that the latest calculated SONIA/LIBOR spread[8] is significantly lower than either the current market implied forward spreads or any of the historical calculations. A persistence of this situation would exert further pressure on existing market spreads.

Table 1: Spread Between 3-month GBP LIBOR and Adjusted RFR

Lookback period	Historical mean	Historical median
5 years	12.409	12.277
10 years	17.891	12.795
Latest calculated spread	5.9693	

Source: Brattle Group, ISDA, Solum Financial Limited

This convergence should prevent an instantaneous value transfer on the adoption date, but this is not guaranteed. In a further attempt to minimise value transfer, the consultation has also decided

[7] Preliminary Results of ISDA Consultation Nov 18

[8] Calculated as of 11-Oct-19

that any variance in the spot spread from the historical observation would be linearly interpolated over a one-year transitional period.[9]

Solum notes that a repricing through a convergence of market implied forward spreads to the calculated historical spread would in effect mean that the value transfer had already occurred, although it would not have been realised by many market participants.

As such, market participants should be performing comparisons of the theoretical calculated spread with the current implied forward spreads in order to make an informed choice about opportunities to transition at more beneficial rates. A passive approach to transition that solely relies on the use of the fallback provisions may result in a negative value transfer that could be prevented. In some cases, it may be more economically beneficial to wait and rely on the fallback spread or a market repricing before transition. However, this delay would need to be considered against the certainty of transitioning in advance.

Solum recommends that a proactive analysis, which assesses potential changes in present value (**PV**) and risk, be performed regularly, either internally or by an independent third party, in order to better manage the timing and impact of transition.

Solum notes any solution proposed by ISDA would only apply to derivatives, raising concerns not only about possible differences in the timing of RFR adoption but also the introduction of new basis risk between related asset classes.

The Requirement for Term Rates

One of the most topical issues is that IBOR rates are set in advance and are therefore forward looking, allowing contractual interest payments to be known at the start of a calculation period. The current proposals envisage that the market transitions to the use of a backward-looking rate where daily RFRs are compounded and interest payments would only be known at the end of a period. The backward-looking nature of RFRs has been highlighted by many market participants as one of the major impediments to successful migration from LIBOR to ARRs.

The introduction of features such as a payment lag (as seen in RFR based Floating Rate Note (**FRN**) issuances) could mitigate settlement issues. However, this would still require a sizeable operational and technological investment in order to implement the necessary structural changes associated with daily RFRs (e.g. in respect of the accrual method of bookkeeping). Although this may be feasible for larger market participants, it is questionable whether the resources needed to make this significant operational and technological change are available, or should even be necessary, for other market participants.

Alternatively, term RFR rates could be the preferred solution. For example, 3-month LIBOR and a 3-month term RFR rate which are both forward looking could be directly substitutable for one another from an operational and technological perspective. Existing systems and processes would not need any major unnecessary and expensive rebuilding, as they would simply be 'consuming' a compounded RFR rate with the same characteristics as LIBOR from a new reference page. This would therefore accelerate transition and support migration to the ARRs prior to a cessation event, greatly reducing the possibility of market disruption, in particular for smaller institutions and end users.

The various RFR working groups are currently researching the mechanisms for constructing term rates from the RFR overnight rates. Any term rate would be constructed using over-the-counter (**OTC**) derivative market transactions and/or futures. Although regulators had initially been wary of using derivatives to construct a term rate, opposition to term RFRs seems to be diminishing. In June

[9] Final Parameters for Benchmark Fallback Adjustments

2019, the FCA's Andrew Bailey commented that SONIA liquidity had reached a point where it was realistic to begin building term rates,[10] although the regulatory and working group view is still that they would only be sanctioned for a subset of the market.

At ISDA's annual Europe conference in September 2019 the FCA's head of markets policy, Rich Fox, commented that any term rates would need to be based on real transactions or actionable quotes and that the FCA was encouraging market participants to quote firm prices on Central Limit Order Books (**CLOB**s) in order to build the liquidity that would allow these venues to construct a term rate. The SONIA working group anticipates publication of term SONIA rates in Q1 2020.[11,12]

Although concerns exist over the construction of a term rate derived from derivatives, a CLOB transactional methodology based on tradeable prices, with deep liquidity to support the fixing, would alleviate concerns and remove the historic concept of 'panel banks', as the access to the venue would be open to all market participants. A further development of any offering could also see the fixing as part of an auction process where all market participants could cross transactions at the fixing price, with volume imbalances in the fixing traded as part of a post fix competitive auction, similar to that used in the government bond markets.

The US working group will also introduce a term rate based on SOFR OTC derivatives. However, unlike the GBP market, where SONIA volumes now account for approximately 20% of risk, SOFR activity is, by comparison, muted and a term rate is unlikely to be introduced until 2021 unless there is an increase in liquidity.[13] A lack of liquidity in RFR derivatives in other jurisdictions has resulted in plans for a term rate to be abandoned, as is the case for SARON, the Swiss equivalent overnight RFR.

It should be noted that liquidity in the underlying derivatives is seemingly a prerequisite for determining the calculation of the missing credit spread in the current ISDA fallback solutions. It is possible therefore that the decision may be revisited when, and if, liquidity emerges.

Regulators acknowledge that the existence of a term rate would facilitate a timelier market transition. Notwithstanding this, they are also keen to point out that waiting for a term rate is not a valid excuse for delaying LIBOR transition planning. John Williams, President and CEO of the NY Fed, recently commented that the industry must not wait for a SOFR term rate to transition away from LIBOR;[14] a comment reiterated by Andrew Bailey who called it a 'mistake' to wait for the emergence of a term solution.[15] Similarly, the February minutes of the SONIA working group showed a willingness to promote the development of a robust International Organization of Securities Commission (**IOSCO**) compliant term rate, but re-iterated that compounded SONIA would be utilised in the majority of transactions.[16]

Unlike a term LIBOR, which includes a credit element, term ARRs do not, as they simply represent expected daily RFR fixings compounded over a given period. As a result, RFR swaps against either a term fixing, or an overnight fixing, are completely fungible prior to the fixing. Unlike LIBOR swaps which include a tenor basis between swaps that fix against 3-month or 6-month LIBOR, RFR swaps of the same maturity against either type of floating leg will have the same expected value. The lack of a tenor basis in ARR swaps would allow a market making bank to offer term RFR swaps to its customers and hedge directly in the overnight RFR swap market at no additional cost, managing its reset or fixing risk in the normal manner.

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[10] Risk - FCA: Sonia derivatives liquid enough to create term rates
[11] https://www.risk.net/regulation/7010556/fca-urges-sonia-swaps-on-to-lit-venues
[12] FTSE Russell - Term SONIA Reference Rates - 14 May 2019 (PDF)
[13] LSEG Support of UK interest rate benchmark reforms
[14] https://www.newyorkfed.org/newsevents/speeches/2019/wil190923
[15] https://www.fca.org.uk/news/speeches/libor-preparing-end
[16] BoE Sterling RFR Working Group February minutes

In Solum's view, an RFR swap market that fixes using a compounded overnight rate will become the standard for market professionals, but it will operate alongside an ARR swap market that fixes against a forward looking 1, 3- or 6-month term rate.

Hedge Accounting and Regulatory Treatment of Amended Trades

The disruption of existing hedge accounting arrangements upon a migration to the new ARRs has been raised as a concern by many market participants. The income volatility that would arise due to the potential de-recognition of an existing hedge, as a result of migration, has led the various accounting standards bodies to issue a number of accounting reliefs.

Breaks in hedge accounting will occur if the hedge fails the effectiveness test or if the documentation that specifies the hedging relationship does not allow for an alternative to LIBOR. These difficulties will be exacerbated if the derivative markets were to transition to RFRs at a different time to the cash-based products they are typically hedging. The introduction of a basis risk will be problematic not only in terms of the effectiveness test of the hedge but also due to the real basis risk that will exist between the two items, regardless of how they are accounted for.[17]

The International Accounting Standards Board (**IASB**) has already allowed firms to consider future LIBOR cashflows as highly probable, removing the concern that any post 2021 movement away from LIBOR would break this key requirement for hedge accounting.

The Financial Accounting Standards Board (**FASB**) in the U.S. issued an update allowing SOFR to be designated as a benchmark interest rate for hedging accounting purposes. In June 2019, it additionally provided temporary relief that any change to a contract reference rate would be accounted for as a continuation, provided it met certain criteria. The proposal however only allows changes to the reference rate and no other terms of the hedged item.[18]

In March 2019 the Basel Committee on Banking Supervision (**BCBS**) published guidance which stated that amendments to legacy derivative contracts, solely for interest rate benchmark reform, would not trigger the margin requirements under the BCBS/IOSCO framework although implementation will depend on the approach of regional supervisors.[19] The U.S. Treasury Department has also provided guidance that no taxable gain or loss will result if the terms of a transaction are modified to replace an IBOR referencing rate where the fair market value does not change.[20]

The Role of CCPs in IBOR Transition

The importance of the role of CCPs in influencing the timing of the transition to ARRs cannot be understated. CCPs have implemented the required changes to their risk management and valuation practices in order to accommodate the clearing of RFR based swaps at the earliest opportunity, a key requirement in building liquidity, as illustrated by the announced switch to SOFR and €STR remuneration (and accordingly, discounting) from Q2 2020.

Such change in discounting methodology at the CCPs will lead to efforts to implement a similar change in the bilateral market by amending existing CSAs however, reluctance of counterparties to amend their CSAs or to settle resulting valuation changes could result in protracted bilateral negotiations or collateral disputes. To avoid this type of market disruption we would expect to see the development of new protocols for legacy collateral agreements as recommended by the European working group.

[17] FASB Exposure Draft
[18] FRED 72 Draft amendments to FRS 102 – Interest rate benchmark reform
[19] BCBS/IOSCO statement on the final implementation phases of the Margin requirements
[20] IRS: Guidance on the Transition from IBOR to other Reference Rates

Agreeing a change in the CSA compensation rate to €STR flat would also require a bilateral cash compensation payment between parties which should in Solum's opinion be independently verified.

Perhaps more important, is the question as to when CCPs will cease clearing LIBOR based derivatives and whether that will be in response to liquidity migrating to RFR derivatives or is in itself the tipping point for a liquidity switch.

In a market where liquidity has migrated to RFR derivatives, Solum would expect CCPs to utilise their ability under their rulebook to switch all cleared swaps to the ISDA defined IBOR fallbacks. The rationale being that in the event of a default, the risk management of a LIBOR based portfolio would be impossible if liquidity was only available in RFR swaps.

It could be argued however that if CCPs were to implement fallback provisions at an agreed date post 2021, then this action itself would switch liquidity to RFR swaps in short order.

As it is envisaged that the ISDA fallbacks will only be implemented upon a permanent cessation of LIBOR, this raises the potential for LIBOR to continue to exist post the end of 2021 date. Any market expectation that LIBOR survives in what has been referred to as a 'zombie status' would undermine the regulatory desire to increase the speed of migration away from LIBOR. In part to avoid this situation, as the benchmark administrator, the FCA has stated it has the authority to determine LIBOR as non-representative ahead of any permanent cessation event. This would prevent any further use of LIBOR as a reference rate in derivatives and would immediately trigger the CCP to implement fallbacks for cleared portfolios. In light of this, ISDA has also consulted on the potential incorporation of a pre-cessation trigger, to be applied in the case of such action by a regulator. This could have the positive effect of aligning transition in the bilateral market to that in the cleared market.

Solum notes that the creation of a non-representative pre-cessation event could be an attempt by the regulators to exert control on the timing of the trigger event, and hence market transition.

The Role of Treasury

Treasury departments should play a pivotal role in managing the transition plan of any institution. A major role of a treasury group is to determine the appropriate Term Liquidity Premium (**TLP**) curve used to transfer price funding across an institution. Maintaining an IBOR based TLP curve restricts the development and pricing of RFR based products by introducing a funding basis risk for individual business lines. In our opinion the migration of TLP curves from IBOR to an appropriate RFR is an internal decision and therefore more easily achieved than some other elements of transition.

Solum notes that some institutions would prefer to see the development of a forward-looking term RFR prior to migration of their TLP curve. A 3-month term RFR would then be substituted for the 3-month LIBOR rate used in current TLP curves. However, as TLP curves are used for internal transfer pricing, it is possible for a Treasury to publish and use its own term RFR rates (such as the prevailing 3mth SONIA, SOFR or €STR prices at 11.00 each day) for use in the construction of internal funding curves.

This approach would anticipate the existence of an official term rate and allow eventual substitution, if required, transition internal funding to the RFR, promote swapping of issuance to RFRs rather than IBOR and encourage further development of RFR based products.

The redesign of the TLP curve presents an opportunity to re-evaluate how Asset and Liability Management (**ALM**) activity is conducted. Treasury via its ALM activity should manage all index basis that exists on a balance sheet. The re-evaluation should ensure that the correct mechanisms are in place to accurately transfer index basis risk back to Treasury to enable effective hedging.

The absence of bank credit spread in RFR assets versus its presence in market-based liabilities has been raised as a concern for profitability in times of market disruption. This potential funding basis should be accurately measured, and risk managed as part of the ALM function.

Recent developments and further considerations.

In the UK market, the decision to select SONIA as the preferred ARR capitalised on the prior existence of a liquid SONIA OTC derivatives market. An additional risk management benefit results from combining the projection and discount curves which removes the LIBOR-SONIA discounting risk embedded in cleared and bilateral contracts. The results of utilising an existing market are more widely seen in other sterling asset classes and it is no surprise that the sterling market has seen the earliest milestone achievements.

According to ICMA, FRNs referencing sterling LIBOR have all but ceased, with new public issuances referencing SONIA. 53 transactions totalling nearly £30bn of SONIA FRNs were issued in the first three quarters of 2019, an increase from the 12 transactions with a total of £6.9bn issued in the whole of 2018.

The first transition of a legacy LIBOR FRN to a SONIA equivalent was reported by Associated British Ports in June 2019, with July 2019 seeing the first reported SONIA based loan from NatWest to National Express. Nationwide also launched the first securitisation referencing SONIA in April 2019 and covered bonds linked to SONIA have also been issued by NatWest, Lloyds and Santander, amongst others.

The case of the FRN transition highlighted the difficulty in achieving the high consent thresholds required for a transition. £30bn+ of UK LIBOR FRNs with maturities post 2021 remain outstanding where the process of gaining consent across multiple investors, who have the right of refusal will be a complex and protracted bilateral dialogue. In the absence of a centralised body such as ISDA to help facilitate the change, some market participants have lobbied the UK regulator to engage the government in order to make the transition easier or compulsory, through legislation. While not ruling out some form of regulatory action, it is Solum's view that this would be difficult to accomplish on a multijurisdictional basis. In fact, the regulators have specified that transition planning should not rely on a legislative solution.

It is reported that October 2019 will see the use of a negative consent clause in the conversion of an ABS from LIBOR to SONIA. A negative consent clause allows transition to occur unless objected to by a predetermined percentage of holders and as a result transition is potentially more easily achieved.

The National Express loan was the result of a bilateral negotiation. Issuance of syndicated RFR loans may be more problematic where all syndicate members would need to be in a position to manage backward looking compounded overnight rates. The introduction of a term RFR would significantly reduce the operational and technological change burden on borrowers and lenders and could increase the pace of transition. However, Solum would highlight the potential opportunities of being 'RFR ready' in terms of product offering and capability as a means to increasing market share. Regulatory feedback has already highlighted the demand for new RFR based products from clients with an apparent lack of RFR product development as a reason for lack of progress in transition.

The BOE has stopped using post 2021 LIBOR based swaps in its hedging activity and in Q3 it is due to publish the results of a consultation on imposing restrictions on eligible collateral for its market operations. In Solum's view, the BOE is likely to impose significant collateral haircuts on LIBOR based collateral. This will further encourage the use of SONIA based products, especially those held for liquidity reasons such as the HQLA buffer and is likely to result in a pricing differential between LIBOR and SONIA collateral.

The ECB's choice of RFR €STR was first published on 2 October 2019. EONIA will no longer exist after 2021 and in the interim period, EONIA will be defined as €STR plus a spread of 8.5 bps, the historical difference between the two rates. Another change will see EONIA switch to T+1 reporting, requiring some infrastructure changes.

The ECB's decision to reform Euribor to make it benchmark compliant means Euribor will continue in the 'medium term' as a reference rate. However, the low volumes of money market transactions require a continued reliance on the discredited use of expert judgement in setting the rate. In Solum's view, the risk of Euribor discontinuation at a future date is significant either due to it being deemed non representative or as a result of market liquidity moving to €STR.

Conclusion

The market transition from IBORs to ARRs represents one of the largest and most far reaching changes in the interest rate market structure ever undertaken. The pervasiveness of IBOR related products and models transcends the normally siloed asset classes and impacts on all market participants, ranging from the largest investment banks to the smallest of users of finance.

Regulators and market participants recognise that a sudden cessation of LIBOR would cause widespread market disruption and threaten financial stability. A seamless coordinated transition to ARRs following a trigger event, across all jurisdictions and asset classes, would envisage a flawless big bang where all the intricately entangled moving parts are executed perfectly. It is therefore not surprising that the regulators are united in the view that the best transition plans are those that migrate transactions to the ARRs before any trigger event.

It remains to be seen if regulators will develop a more punitive approach to those institutions that, in their view, are not taking significant enough transition actions. Recent rhetoric has expressed displeasure at the (lack of) pace of change and at the continued origination of LIBOR based products. In October 2019, the Bank of England's Financial Policy Committee (**FPC**) stated that it would consider further policy tools to ensure the reduction of legacy LIBOR contracts[21] meaning such an approach cannot be ruled out.

Conversely, in recent months, there have been significant reliefs from the regulators and other governing bodies. These seek to remove accounting and tax obstacles to an early transition and have also clarified exemptions from the clearing and margining mandate. With the imminent publication of the ISDA fallback provisions, (for certain currencies) it now appears that market participants have the required tools with which to take informed decisions on the benefits of an early migration of legacy transactions.

The publication of a term ARR fixing would facilitate a smooth transition for many sectors of the market, as it would certainly remove several significant obstacles, but it cannot be guaranteed. As a result, transition planning must envisage a market without a term ARR in such a way that its introduction would accelerate ARR adoption rather than being a prerequisite.

Clearing of ARR derivatives and a move to ARR discounting at CCPs and potentially in CSAs also, will inevitably drive volumes of ARR based activity higher. If regulators are successful in curtailing the availability of LIBOR based products, it is possible that market liquidity switches to ARR based products prior to any cessation event. In addition, a switch in liquidity will be reinforced upon a CCP enforced migration of cleared trades.[22] This would result in non-cleared legacy portfolios with either increased liquidity costs for early transition or acceptance of the fallback solution.

[21] October 2019 FPS and record

[22] LCH position respects ISDA's recommended benchmark

A mechanism for large scale portfolio migration to ARRs, especially in derivatives, does not currently exist and migration is therefore reliant on bilateral negotiation. The introduction of a regulatory approved multilateral migration tool would result in a dramatic reduction in the stock of legacy LIBOR based derivatives.

Reliance on the fallback solutions has the potential for adverse value transfer with all the operational and conduct risk of a ‘big bang’. Acceleration of transition activity will result in those market participants who fail to migrate early, increasingly at risk to market dislocation and a suboptimal outcome.

The direction of travel is known, and solutions are increasingly being developed to address obstacles to a successful market transition. Solum expects to see further milestones achieved in the coming months as market participants move from a passive ‘wait and see’ to a more proactive approach.

If you would like further discussions on any of the issues raised or a demonstration of the relevant Solum analytic solutions, please contact us.

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