Centrus

Modern Finance

Market transition from LIBOR to SONIA

White paper

November 2018

LONDON | DUBLIN

Following the various travails of LIBOR over the last few years, the Bank of England set up the “Working Group on Sterling Risk-Free Reference Rates” that recommended, in April 2017, the Sterling Overnight Index Average (or “SONIA”) as their preferred risk-free rate for Sterling. Since this recommendation, the Working Group has focused on how to migrate from LIBOR to SONIA across Sterling markets.

Executive Summary

Following the various travails of LIBOR over the last few years, the Bank of England set up the "Working Group on Sterling Risk-Free Reference Rates" that recommended, in April 2017, the Sterling Overnight Index Average (or "SONIA") as their preferred risk-free rate for Sterling. Since this recommendation, the Working Group has focused on how to migrate from LIBOR to SONIA across Sterling markets.

From the end of 2021, Sterling LIBOR will no longer be available as the Financial Conduct Authority ("FCA") considers that it will no longer be necessary "to persuade, or compel, banks to submit to LIBOR".

The move away from LIBOR is inevitable and will impact a large variety of transactions such as debt capital market securities, bank loans, hedging arrangements, and bank deposits among others. There will be a range of connected changes over the next few years and there are a number of areas in which we do not yet know the details.

But there are some natural areas for analysis and potential action in the short term such as review of existing loan and hedging documentation, for the prevalence of LIBOR language and for the purpose of gaining a clear view around the vulnerability to changes imposed by counterparties without due process or fair consideration of corporates' requirements. To be clear, there are areas where there is a risk that banks or other counterparties seek to impose outcomes on borrowers which are not fair and we have already seen examples of that and supported clients in negotiations on these points.

Since the picture will change over time it is important to follow developments as matters progress. There are some areas, such as the potential construction of a "term structure" based on SONIA, where the issue is well understood and a project plan is emerging with significant involvement by regulators. There are others, such as the choice of discount rate for hedge valuation or the adaptation of the payment basis for floating-rate notes, where it seems possible that it may be left more to commercial negotiation between the parties.

"Since the picture will change over time it is important to follow developments as matters progress."

We believe that corporates as well as financial institutions should consider this transition as part of their 2019 treasury priorities. It is important to analyse the portfolio of affected (existing or anticipated) debt and hedging transactions, consider economic, accounting and operational aspects of the transition and monitor ongoing relevant regulatory developments. Where there are genuine commercial issues around changes to existing documentation it is important to identify that and establish a strategy for achieving a reasonable outcome.

Centrus offers expertise in the technical issues and significant experience in supporting effective commercial negotiations. As independent debt and derivative advisors we are expecting to increase the level of engagement with clients – which we are already starting to see during 2018 – on this issue during 2019.

Background

The early 1980s saw a rise in the trading activity of a variety of new market instruments, notably interest rate swaps, foreign currency options and forward rate agreements. This led to the need for a uniform, standard benchmark to price this array of financial products. In October 1984, the British Bankers' Association, working alongside the Bank of England and other interested parties, began work on a new rate. The "BBAIRS" term (British Banker's Association Interest Rate Swap) was created, setting a standard for interest rate swaps, and in January 1986 the first London Interbank Offer Rate ("LIBOR") was released.

LIBOR is constructed by taking quotes from a range of banks on how much they would be charged in interest to borrow money on a short-term basis from another bank. The outliers are excluded and an average is taken, which is published at 11 am (London time). LIBOR is calculated by the Intercontinental Exchange ("ICE") and published by Thomson Reuters. It is published across five currencies and a range of tenors.

LIBOR and other "IBOR" rates have historically underpinned a huge range and volume of financial transactions and they have been entrenched within the global financial system.

This paper focusses just on the UK and Sterling, where GBP LIBOR is used by borrowers and lenders, including banks and financial institutions, as the reference rate for various corporate debt instruments. It is also used as a benchmark for mortgages, government bonds, credit cards and student loans in various countries, along with various other "non-financial documentation" uses such as insurance valuations and late payment clauses in commercial contracts. Apart from debt instruments, LIBOR is also used for other financial products such as derivatives including the mainstay vanilla products of interest-rate swaps and cross-currency swaps.

Causes for the transition away from LIBOR

Most of these uses would logically have started with a risk-free rate but of course in the real world there is no such thing as a completely risk-free rate (even overnight). LIBOR was understood not to be truly risk-free but was seen as a robust benchmark and with a relevant grounding in the extensive market of inter-bank lending, which of course prior to the financial crisis was in any event seen as pretty low risk. However, the financial crisis and subsequent ongoing changes to the financial system over the last decade have left it looking a great deal less robust.

There are two main causes, apart from greater awareness that banks are not risk-free institutions: firstly, the reduction in the scale of inter-bank lending; secondly the challenge presented to the credibility of LIBOR from the realisation that a number of participating banks were manipulating it for their own benefit. In 2012, following substantial fines being imposed on various international banks, the UK government conducted the Wheatley Review which called for reform of LIBOR. Across the globe similar changes are being made to the other IBOR rates.

In 2015, the Bank of England set up the "Working Group on Sterling Risk-Free Reference Rates" tasked to develop alternative benchmark rates ("RFRs") for use instead of LIBOR. In April 2017, this group recommended the Sterling Overnight Index Average (or "SONIA") as their preferred risk-free rate for Sterling. The main perceived benefit of SONIA, which itself has been around for a while too, is that it is based on daily transactional data rather than quotes from participants as to what they claim they would be charged. Since this recommendation, the Working Group has focused on how to migrate from LIBOR to SONIA across Sterling markets.

From the end of 2021, Sterling LIBOR will no longer be available as the Financial Conduct Authority ("FCA") considers that it will no longer be necessary

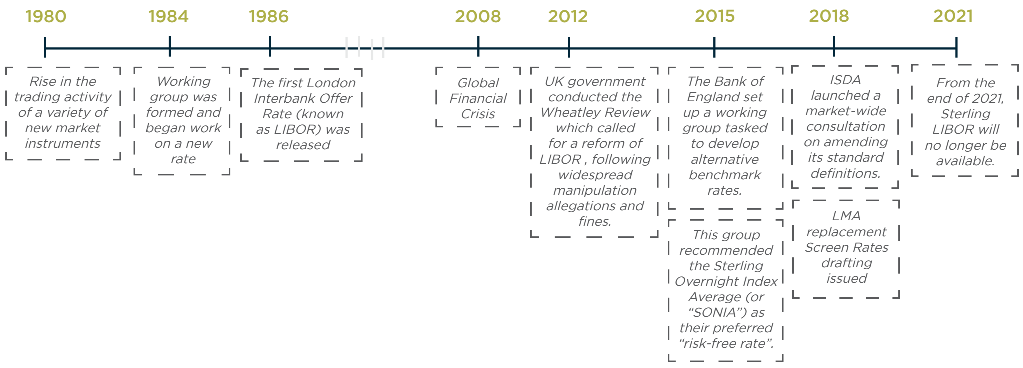
> *"to persuade, or compel, banks to submit to LIBOR" or "to sustain the benchmark through our influence or legal powers".*

Andrew Bailey, Chief Executive of the FCA, summarised the real-world issues with LIBOR neatly in a speech he gave in July 2018, observing that:

> *"[SONIA] is now supported by an average of 370 transactions per day... the average daily count of deposit transactions that would potentially qualify as inputs to six month LIBOR – the most commonly used of the sterling LIBOR rates – was just 2 in the past 6 months. LIBOR could not achieve the same robustness as SONIA even if the LIBOR panels included all banks in the market. SONIA, unlike LIBOR, does not use, and has no reliance on submissions based on expert judgement."*

The following chart summarises the timeline:

Figure 1:
LIBOR - SONIA
transition timeline



1980: Rise in the trading activity of a variety of new market instruments

1984: Working group was formed and began work on a new rate

1986: The first London Interbank Offer Rate (known as LIBOR) was released

2008: Global Financial Crisis

2012: UK government conducted the Wheatley Review which called for a reform of LIBOR , following widespread manipulation allegations and fines.

2015: The Bank of England set up a working group tasked to develop alternative benchmark rates.

This group recommended the Sterling Overnight Index Average (or "SONIA") as their preferred "risk-free rate".

2018: ISDA launched a market-wide consultation on amending its standard definitions.

LMA replacement Screen Rates drafting issued

2021: From the end of 2021, Sterling LIBOR will no longer be available.

The FCA is concerned that preparations are not as advanced as they would like but appear to be holding fast to their intention to move away from LIBOR. To be clear: our view is that this is going to happen. Even if the Bank of England does not use regulatory action to stop or discredit any attempt to keep publishing LIBOR, it will be discredited and no one will be required to make submissions after 2021. Banks will not want to provide this legacy data and to take the unnecessary reputational and legal risks involved.

Implications

There are two clear strands to effecting a change-over: firstly, transitioning away from LIBOR in new contracts, and secondly dealing with LIBOR in legacy contracts including potentially some challenging negotiations with investors and hedge counterparties.

The following table summarises the key issues for corporates:

Table 1: Key Issues for corporates

	New contracts	Legacy contracts
Funding	• Basis for floating-rate issuance and bank debt • Basis of intercompany funding	• Interpretation of LIBOR references in existing financing documentation
Risk management	• What basis to use for derivatives with regards to both valuations and settlements • Impact on hedge accounting – effectiveness testing and documentation • Collateral calculations	• Pricing and valuation of existing derivatives • Restructures of existing trades • Hedge accounting • Collateral calculations
Operational	• Lack of term structure – synthesise or rely on backward-looking rates • Systems changes likely to be required	• Term structure, depending on position reached in the market • Legacy positions in legacy systems – updating and reconciliation

Replacement: SONIA

SONIA is administered by the Bank of England and was recommended in April 2017 as the RFR replacement for LIBOR by the Working Group referred to above. SONIA is a rate paid on wholesale unsecured overnight loans. It has been in existence since 1997 and has recently been reformed to include a wider pool of transactions in preparation for its use as the Sterling RFR. Other countries have made similar choices although, for example, the US is using a rate based on repos (the “Secured Overnight Funding Rate”).

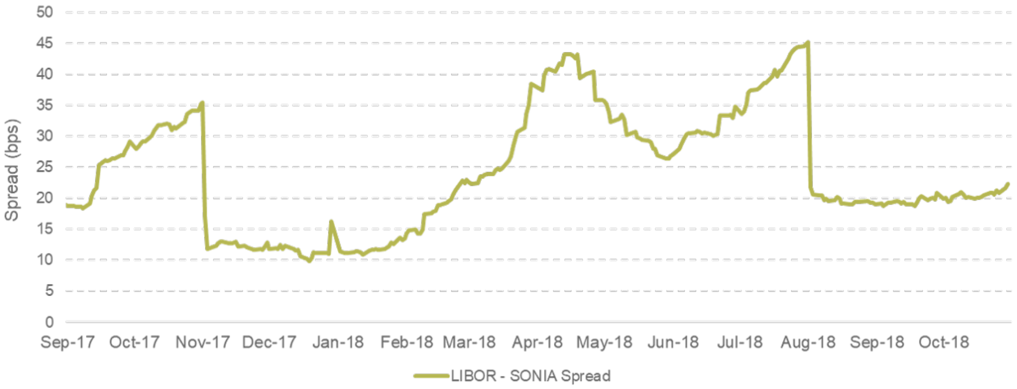
SONIA is calculated as the weighted average of the interest rates charged for all unsecured loans reported by market participants in the London overnight market. Only deals of £25m or more are considered as part of the average. It is a daily rate and has no term structure or bank credit spread, whereas LIBOR of course has both. SONIA-based financial instruments at present accrue interest using the daily rate which is then compounded over the relevant time period and of necessity calculated in arrears.

SONIA is constructed from actual transactions rather than quotes provided by banks (as with LIBOR). Using this methodology should, in theory, reduce the possibilities of market manipulation. SONIA is already used as the reference rate for Sterling Overnight Indexed Swaps (“OIS”) a simple interest-rate derivative swapping a fixed-rate leg against the SONIA floating rate over a set period.

Centrus clients may be familiar with SONIA from our daily market data sheet where we provide the spread between 3-month OIS swaps, based on SONIA, and 3-month LIBOR, as a measure of perceived risk in the banking system. In a credit-risk-free world they would be very close. Lending a bank money at 3-month LIBOR involves taking credit risk for a fixed three-month period on the principal lent, unlike a swap, and therefore a larger spread between the two is seen as indicative of greater concern over bank credit quality.

The chart below illustrates the spread between SONIA and 6m LIBOR over the past 12 months. Some clients are monitoring the spread closely for market opportunities to lock in a beneficial difference now (rather than take the risk of the spread narrowing between now and 2021) and there is a case for taking action, should opportunities present themselves e.g. explicitly to restructure to SONIA-based positions.

SONIA
LIBOR - SONIA Spread



The immediately obvious comment to note, looking at the chart, is that there is quite a lot of movement in the basis spread. it is sufficiently material and volatile that anyone with existing LIBOR-based positions (loans or derivatives) ought to care about the fact that the transition will not simply be to cross out "LIBOR" and replace with "SONIA".

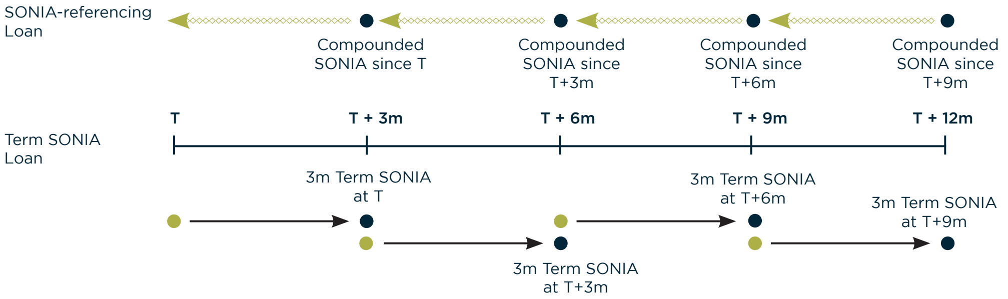
SONIA Funding – Lack of Term Structure

There is a key practical challenge with the abolition of LIBOR. The LIBOR index is published daily on various terms including one, three and six-month forward-looking periods, but SONIA is published daily first thing in the morning just as a (historic) overnight rate. A loan which simply references SONIA over a period would require daily compounding, taking the realised fixing for each day in the interest period and compounding it for a calculation at the end.

Alternatively, a "Term SONIA Reference Rate" could be used, for example with expected average SONIA used over a given period. It is important to realise that at present there is no such "term product" in existence and should one be created it will require a set of agreed practices around what market data is used and how.

For bank financing, and particularly for smaller corporates with limited operational resources, the lack of term structure is a key practical issue. The example below illustrates how the two basic concepts – daily calculation vs. a term product – might each work for a one-year facility with quarterly interest payments.

SONIA
Daily calculation
vs. term product



In our view a central question here is whether we really do need to have a term structure to the market RFR. Settlement mechanism on derivative transactions could simply work with a "backwards-looking" daily-compounded rate. There would then be a basis mismatch if loans used a forward curve set at the start of each roll period so there is an argument for everyone simply to move to the SONIA-referencing approach. That is not what many smaller corporates presently want, but it does seem possible that larger corporates (and banks) will prefer to align loans and derivatives and rely on a single benchmark, SONIA, and that the "term structure" concept may as a consequence fall by the wayside.

Whilst not knowing one's interest costs part-way through a roll period seems less than ideal, arguably the risk is not so different from not knowing the interest payment for the following period, assuming that at least some loans will continue to be drawn in that next period and there is limited planning that can be done around the costs (assuming they are not hedged).

The challenge around this level of change is partly just perception but in the financial world "perception" quickly of course becomes "trust" and if regulators want one thing they want people to trust the system. Smaller corporates are perfectly happy being able to budget on the basis of interest rates which are known at the start of each roll period, and it requires less in terms of a data and systems overhead and cost.

So we may end up in a world with some agreed basis for calculating a series of look-forward term rates, based presumably on OIS market data, or in a world with everyone using SONIA for loans. The latter represents the bigger change from a "common sense" perspective but the former is arguably more complicated and indeed we would then probably see a split of product types with some corporates preferring to stick to SONIA for loans as well as derivatives.

> "Emerging practice appears to be to take a simple approach to one practical issue, the timing of interest calculations"

SONIA in Debt Markets

There has been movement towards SONIA in debt markets. Financial institutions have started the transition into SONIA-based instruments with the following three notable transactions:

- The European Investment Bank ("EIB") issued a £1bn SONIA-linked bond at the end of June 2018.
- Lloyds Bank issued a £750m SONIA-linked bond earlier in September 2018.
- The World Bank issued a £1.25b SONIA-linked bond at the end of September 2018.

Emerging practice appears to be to take a simple approach to one practical issue, the timing of interest calculations: all interest payments are based on SONIA as of five business days before the coupon payment. This means that there is in principle enough time to perform the calculations before initiating cash settlements and this may be a useful template going forward for fresh or restructured transactions although there are other potential methods also.

Anyone who has been involved in a non-standard transaction will be aware that the devil can be in the detail of compounding methods, rounding, when the margin is applied in the calculation, drafting of fall-back arrangements, etc. But the point has been made that investors are prepared to invest on this basis even while some elements of the wider jigsaw remain moving.

In the bank market we have seen examples of one-sided and unacceptable language proposed by lenders on new facility documentation (where the replacement of LIBOR in due course is basically proposed to be at the bank's discretion) and the recent Loan Markets Association ("LMA") drafting for replacement "screen rates" released on 17th October is helpful but inevitably lacking the full detail required in due course in our view.

SONIA in Derivatives Markets

LIBOR is of course used in the calculation of many derivatives' cash flows and their mark-to-market ("MTM") valuations. There is a "SONIA market", which is somewhat more progressed than SONIA funding, with SONIA derivatives – such as OIS swaps described above – being traded in the Over The Counter ("OTC") market since the inception of SONIA in 1997. OTC contracts are traded directly between two parties without the supervision of an exchange so potentially present practical issues around data quality and consistency. But there is significant cleared volume now and London Clearing House reports that while the notional of outstanding GBP OIS swaps is less than that of conventional swaps, YTD for 2018 the trading volume is higher in OIS.

The fact that SONIA is already gaining traction in the hedging market means at least that the basis can be observed and potentially form the basis of a strategy for converting trades across in good time:

> “However, there are important nuances in the treatment of historic swaps and other derivatives”

- Approximately 15% of PV01 (present value of a basis point – a more appropriate measure of market size than notional as it takes in to account duration – is now in SONIA-linked swaps and liquidity continues to grow. At some point, liquidity will thin in the LIBOR swap market and pricing may simply become a function of the SONIA curve plus the ISDA fall back spread, or indeed it may influence what might be the appropriate spread depending on how matters develop and when.

- Three-month SONIA futures were launched on two exchanges in the spring (ICE and the London Stock Exchange). Volumes are currently low but are expected to grow and eventually replace Short Sterling LIBOR futures. Since market participants frequently use the very liquid futures market to construct discount curves at the short end, this is an important complement to the development of a swaps market.

The transition of legacy contracts to SONIA would be expected to be on the basis of a spread being added to the SONIA floating rate. The International Swaps and Derivatives Association (“ISDA”) launched in July 2018 a consultation looking at “fall backs” for the situation where LIBOR and other IBORs are permanently discontinued. There are a number of options but a clear expectation that some number will need to be added to SONIA when replacing LIBOR in this context. A spread as large as possible would, in cash flow terms, be most beneficial to a corporate using LIBOR-based derivatives, assuming that derivatives contracts are largely “receive floating”.

Application to SONIA to existing derivatives transactions

There is an obvious directional preference for “the rate” in terms of corporates vs. banks in many cases. However, there are important nuances in the treatment of historic swaps and other derivatives. The same issues largely apply to fixed rates within loans where the ‘break’ cost involves a cost indemnity similar to swap close-out language (indeed such provisions often use ISDA jargon).

- Firstly, “the rate” features in two parts of the calculation: the determination of the floating-rate leg in, for example, an interest-rate swap and (ii) the determination of discount factors for discounting future payments.

- Secondly, MTM is used for various reporting reasons including in statutory accounts, with or without the overlay of hedge accounting, but alongside (i) financial reporting purposes it is used for (ii) calculating the economics of restructures including close-out payments and (iii) determining collateral requirements.

As regards the first point the easy part is the determination of the floating-rate leg: an adjustment will in due course be promulgated by ISDA, hopefully, informed by the above “fall backs” consultation. We will have to see how complex an approach they land on. A swap which was “LIBOR vs. x%” will become “(SONIA + y%) vs x%”.

There is an obvious directional preference for “the rate” in terms of corporates vs. banks in many cases. However, there are important nuances in the treatment of historic swaps and other derivatives. The same issues largely apply to fixed rates within loans where the ‘break’ cost involves a cost indemnity similar to swap close-out language (indeed such provisions often use ISDA jargon).

Firstly, “the rate” features in two parts of the calculation: the determination of the floating-rate leg in, for example, an interest-rate swap and (ii) the determination of discount factors for discounting future payments.

Secondly, MTM is used for various reporting reasons including in statutory accounts, with or without the overlay of hedge accounting, but alongside (i) financial reporting purposes it is used for (ii) calculating the economics of restructures including close-out payments and (iii) determining collateral requirements.

As regards the first point the easy part is the determination of the floating-rate leg: an adjustment will in due course be promulgated by ISDA, hopefully, informed by the above “fall backs” consultation. We will have to see how complex an approach they land on. A swap which was “LIBOR vs. x%” will become “(SONIA + y%) vs x%”.

> “Accounting for derivatives is supposed to be about “fair value”, so is hedge accounting, so are actual transactions (witness the above commentary on debates over discount rates)”and so of course are collateral requirements”

The discount rate – the second limb of the “the rate” bullet point above – is much more complicated. It is seen by banks, in the main, where there is the requirement to collateralise positions (regardless of any unsecured threshold) in cash or a reference in documentation to a price calculated on that basis, that the discount rate used should be based on the SONIA discount curve i.e. the OIS market. If you are “out of the money” naturally one might prefer to be using a heavier discount rate. The position where there is no collateralisation with cash is less clear-cut but in practice we frequently see banks stake out the same position. There is some logic to this: SONIA and OIS are the best approximation to a risk-free rate and a cash-collateralised derivative is (nearly) free of counterparty risk and moreover any interest earned on collateral will be earned at SONIA.

For borrowers with large negative MTM positions the difference between this and LIBOR discounting can be material. A bank recently made a case, for a restructure we were advising on involving an interest-rate fix embedded in a loan and with a life of around 50 years, that they were sufficiently wedded to using SONIA that even using the (slightly higher) gilt rate was unreasonable, let alone using the LIBOR swap curve to determine discount factors for the future cash flows. We observed that it was perhaps a coincidence that this served their commercial interests but in fairness the banks have been using this for both sides of their balance sheets for some time and the view has a modest amount of merit. But it is not clear-cut. Arguably the more pertinent commercial point is that when the transaction was entered into the market standard was LIBOR with its implicit bank credit risk element and any close-out might reasonably reflect that original implicit agreement.

To conclude on this particular area: our view is that on voluntary early termination of hedging positions, corporate clients should review the documentation and if it makes explicit reference to “cash collateralised price” then the bank will likely propose use of a SONIA discount curve and and this approach has some merit. But banks do not have 100% of the argument and the corporate may wish to take a view in the broader context of the relationship. Where there is no such clear nod to cash pricing, our view is that there should be a robust line that LIBOR discounting is appropriate with a view to sharing in the funding benefit of closing the position out and the reduction in counterparty risk for the bank.

Without wishing to explore every nuance in this short paper, these is a connection here to the application of valuation adjustments for credit risk and funding costs. To the extent that banks are required to provision against valuations for these reasons there ought also to be room for manoeuvre in the calculation of close-out prices and any lack of movement represents a rather one-sided outcome. While the commercial reality may be that the close-out is a request of the corporate, that does not need to set a precedent for others and any corporate finding itself on the losing side of these arguments involving a material sum may wish to consider the implications for future business. There may be merit in proposing a unified front across certain sectors or products but at the time of writing the consideration of these issues is at a relatively early stage. It is worth noting that these valuation adjustments do not apply to embedded fixes, common in some sectors e.g. housing associations.

Turning to the second bullet point above, the wide set of uses for derivatives MTMs, the basic principle is that they should all be the same. Accounting for derivatives is supposed to be about “fair value”, so is hedge accounting, so are actual transactions (witness the above commentary on debates over discount rates) and so of course are collateral requirements. Having said that, should a reporting entity find that its banks insist on SONIA discounting but there be no intention to restructure and a view that LIBOR-discounting, perhaps with an adjustment for credit risk, is more appropriate for financial reporting… then these in-principle identical numbers could easily diverge.

"Changes to legal documentation, treasury systems, data sources, internal models and pricing curves used throughout an organisation introduce significant operational risk."

Impact on Clients

We have referred or alluded to the main issues arising from the abolition of LIBOR (and other IBORs) in the above analysis, but to summarise:

New contracts and existing contracts

A wide range of existing and new contracts will need references to SONIA or SONIA-based concepts. We can predict with a reasonable level of confidence that there is scope for real wrangling over aspects of this.

Most financial instrument documents include provisions to guide how the interest rates would be set if LIBOR is no longer available, but these are not the solution as they are typically drafted just around temporary disruption.

Fall-backs ought to be based on the relevant RFR, with an adjustment to minimise any value transfer at the point at which the fall-back is triggered. Both ISDA and LMA are now engaged but it is work in progress. One scenario is that we see ISDA arriving at reasonable conclusions on the adjustments for LIBOR legs in swaps which can then inform the approach to other products.

Term structure

We discuss above the potential outcomes regarding whether or not there is to be a "Term SONIA". Either outcome – but perhaps particularly the lack of a Term SONIA or the scenario where there is one but a particular entity chooses not to use it – may affect treasury policies and commercial strategies as well as accounting presentation and operational matters such as budgeting and systems.

Operational Risk

Changes to legal documentation, treasury systems, data sources, internal models and pricing curves used throughout an organisation introduce significant operational risk. It will be important not just to leave this to a couple of individuals in isolation and organisations should consider putting appropriate governance arrangements in place to manage the process and ensure that appropriate resource is available. The systems aspect affects many areas from cash management to financial reporting. Clearly an important aspect of this is whether or not there is going to be a forward-looking rate with a term structure and, if there is, whether organisations do indeed use it.

Changes in the benchmark being used and calculating the relevant spread applied to existing LIBOR contracts introduces an element of conduct risk, perhaps more so for banks and investors but also for borrowers e.g. in relation to risk reporting in prospectuses.

Hedge Accounting

Moving hedging to a SONIA basis, but with the underlying debt unchanged – should that be the outcome – could lead to ineffectiveness in any hedging relationships with the basis risk introduced. The basis difference would arise if actual positions were more different to e.g. a cash flow hedge's "hypothetical derivative" than they already are. This area may entail changes in accounting standards but even if that is not necessary there will be an exercise in auditor engagement and ensuring that there is a clean narrative from documentation to calculation, particularly if there are material transition measurement issues.

Changes to hedge relationships and measurement could have a material impact on P&L if efficiency of relationships is significantly impacted although in practice it may be that the impact is not great compared to the levels of ineffectiveness which already exist in many portfolios.

Liquidity in new underlying markets

As noted previously, there is currently limited liquidity in new SONIA products. This is something that needs to develop over time and momentum is needed to drive the transition across the market. Given the clearer direction now on the chosen risk-free rate, momentum is likely to develop over the next 12 months. For markets to develop properly they need participants who are informed and have clear objectives and this needs to involve corporate market participants as well as the banks.

> "Consider the adequacy of existing treasury systems, from spreadsheets and day-to-day procedures to systems and data provided by third parties."

Derivatives

Terminology in derivatives contracts determines the potential unwind costs for a derivative. Take for example a standalone swap: if the unwind clause is stated as "cash collateralised price" there is more rationale for an unwind value based on SONIA discounting, whereas if this is not included we would expect LIBOR discounting to be assumed. This is discussed in detail above along with related matters such as collateral calculations. Given SONIA is lower than LIBOR, for out-of-the-money positions (the common position for any older position given falls in rates over the last decade) this results in "less heavily discounted" discount factors and a greater break cost to the corporate. There is an argument for establishing and communicating to hedge counterparties a clear commercial position on these issues.

The use of SONIA for closeouts represents an economic loss to clients as swap break costs (for out of the money positions) will be larger than it would have been had LIBOR been used. It does not necessarily mean any change in economic value for the purposes of risk-management decisions or financial reporting.

However, these conclusions need to be considered further once full clarity emerges with regards to not only the discounting process but also the forecasting process, as the LIBOR leg will move to SONIA plus a spread. The relevant spread to be applied over SONIA is still up for debate with no definitive answer at this stage but with guidance expected in due course from ISDA.

In the meantime, we are seeing an increase in client activity considering the appropriate format for their hedges and clients are beginning to consider moving derivative contracts to a SONIA basis or, when entering into new transactions, undertaking these on a SONIA basis. We can provide support for this whether in terms of analysing the commercial significance of the various scenarios or advising on strategy given existing relationships.

Conclusion and Next Steps

There will be a range of actions over the next few years to address this change, including the changes for which we do not yet know the details. But there are some natural areas for analysis and potential action in the short term:

- Review existing documentation, both for the prevalence of LIBOR language (which should not come as a surprise hopefully) but also for the purpose of gaining a clear view – based on the nuance of existing drafting – around the vulnerability to changes imposed by counterparties without due process or fair consideration of corporates' requirements.

- Consider the adequacy of existing treasury systems, from spreadsheets and day-to-day procedures to systems and data provided by third parties. Businesses should expect insight and support from third-party service providers in preparation for the transition away from LIBOR. Particularly if there is an intention to adopt SONIA-based products "ahead of time" it will be important to have systems which are able to cope with that.

- Review of hedging strategies and documentation for the latitude in relation to this change and the potential impact in terms of hedge ineffectiveness. For example, whether loans and hedges are constructed around one-month or six-month LIBOR will clearly make a difference should loans move to some alternative term structure basis with swaps pegged to backwards-looking compounded SONIA.

- Derivatives valuation: some of the banks appears to consider that the move to SONIA for calculating MTM has already happened, but their customers have not all yet reached that conclusion. This is more pressing than sorting out loan documentation for some corporates. This unfinished debate affects valuation for transactional and collateral purposes (and the use of cash collateral or no collateral, or non-cash collateral, itself affects the analysis).

Contacts

For further advice on this area please contact:

George Karalis
george.karalis@
centrusadvisors.com
+44 (0) 7955 397737

Jonathan Clarke
jonathan.clarke@
centrusadvisors.com
+44 (0) 203 846 5675

Adrian Li
adrian.li@
centrusadvisors.com
+44 (0) 203 846 5709

Jonathan Cawdron
jonathan.cawdron@
centrusadvisors.com
+44 (0) 203 846 5687

- Determination of a strategy for new transactions e.g. whether to move to using SONIA products, whether to push for appropriate language in new loan agreements or wait for market consensus to be established, or whether to lobby / work with industry / regulatory / professional bodies. Do you see it as important to have a forward term structure or would you prefer to have loans and derivatives aligned around a single RFR constructed from SONIA on a backwards-looking basis?

- Strategy relating to existing positions i.e. whether to transact away from LIBOR before a solution is imposed or whether to make an informed decision to wait for the issues to be considered fully by all parties, at which time a consensus solution may be reached and (effectively) imposed. It is appropriate to document the reasons for either approach, even if the immediate action is "wait and see".

The move away from LIBOR is a regulatory decision that will affect debt capital markets, bank markets and derivatives transactions among others. It will be fully in effect from 2021 but the picture will emerge over time and it is important to be on top of the stage of progress. We believe that corporates as well as financial institutions should consider this transition as part of their 2019 treasury priorities.

We recommend that treasury teams should:

- Prioritise this theme in 2019
- Analyse the portfolio of affected (existing or anticipated) transactions
- Consider, where relevant, what stance to adopt in relation to historic rate-fixing and derivatives positions
- Monitor relevant regulatory developments
- Consider economic, accounting and operational aspects of the transition
- Develop a clear plan and consider what level of reporting to boards and senior management is appropriate.

About Centrus

Centrus is an independent financial services group that believes in a better way of doing business. We specialise in corporate finance, analytics and investment management and are united by a culture that values imagination, energy and purpose.

We believe this can unlock significant value for our clients and their communities. Above all, we're working towards a more modern financial landscape. It is a simpler and more responsible way of doing business by delivering real money and tangible benefits to the real economy.

Centrus

Modern Finance

DUBLIN

We Work Iveagh Court
Block D, Harcourt Rd
Dublin 2, D02 VH94
Republic of Ireland

+353 (1) 653 9639
dublin@centrusadvisors.com

LONDON

10 Queen Street Place
London
EC4R 1BE
United Kingdom

+44 (0) 203 846 5670
london@centrusadvisors.com

centrusfinancial.com

Important Disclaimer

"Centrus Group" consists of Centrus Corporate Finance Limited and its three wholly owned subsidiaries; Centrus Financial Advisors Limited, Centrus Advisors Limited and MDT (UK) Limited. Centrus Corporate Finance Limited is a limited company incorporated in England and Wales number 07943605. MDT (UK) Limited is a limited company incorporated in England and Wales number 2036221. Centrus Financial Advisors Limited is a limited company incorporated in England and Wales number 10203539. Registered office for all UK legal entities is at 10 Queen Street Place, London EC4R 1BE. "Centrus MDT", "Centrus Advisors" and "Centrus" " are trading names of Centrus Financial Advisors Limited. Centrus Financial Advisors Limited is authorised and regulated by the Financial Conduct Authority Firm Reference Number 750011. Please visit www.fca.org.uk for more information. Centrus Advisors Ltd is a limited liability company incorporated in Republic of Ireland number 547394. Registered office at We Work Iveagh Court, Block D, Harcourt Rd, Dublin 2. Directors: P Jenkins (UK) and J Murphy (Managing Director). Centrus Advisors Ltd is a Tied Agent of Centrus Financial Advisors Limited, which is authorised and regulated by the Financial Conduct Authority.

This report or document or any of its content must not be distributed or passed on, directly or indirectly, to any other person without the express written consent of Centrus. Nothing within this document should be construed as investment advice and should not be relied upon.

All of the views expressed in this report or document accurately reflect the personal views of the responsible analyst(s). The information contained in this report or document has been compiled by Centrus from sources and using data believed to be reliable and unless stated otherwise should be assumed to be using end of day data, but no guarantee, representation or warranty, express or implied, is made by Centrus, its affiliates or any other person as to its accuracy, completeness or correctness. Centrus is under no obligation to update, modify or amend the information. All opinions and estimates contained in this report or document constitute Centrus' judgement as of the date of this report or document, are subject to change without notice and are provided in good faith but without legal responsibility.

This report or document is not an offer to sell or a solicitation of an offer to buy any securities. This material may be prepared for general circulation to clients and may not have regard to the particular circumstances or needs of any specific person who may read it. To the full extent permitted by law neither Centrus or any of its affiliates, nor any other person, accept no responsibility for and shall have no liability for any loss (including without limitation direct, indirect, consequential and loss of profit), damages, or for any liability to a third party however arising in relation to this report or document (including without limitation in relation to any projection, analysis, assumption and opinion in this report or document).

Data is sourced from various sources including Bloomberg, Markit and Centrus Datasheet.