# Implications of Covid-19 on the IBOR Transition

LPA Consulting

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With the Coronavirus pandemic unfolding and threatening banks financial health, countries, central banks and other financial institutions worldwide are taking remedial actions to calm down the markets.

In the following we would like to emphasize three aspects of the IBOR transition impacted by the Coronavirus crisis: (1) impact on deadlines, (2) rising banking risk premiums and (3) the behavior of SOFR under stress.

**Implication on regulatory deadlines**

On March 12, 2020, the European Central Bank (ECB) released a plan, to provide temporary capital and operational relief. In their press release, it was announced that "the ECB is discussing with banks individual measures, such as adjusting timetables, processes and deadlines. For example, the ECB will consider rescheduling on-site inspections and extending deadlines for the implementation of remediation actions stemming from recent on-site inspections and internal model investigations, while ensuring the overall prudential soundness of the supervised banks." The imminent Securities Financing Transaction Regulation (SFTR) go-live was already postponed, while the IFRS 17 deadline is under discussion.

During the crisis, banks need their staff for more pressing tasks, like contingency planning, coping with the economic impact and dealing with capital and liquidity risks, than working on the IBOR transition.

However, it is unclear whether regulators will follow the lead. Since the IBOR transition is more market- than regulatory-led, much depends on the reaction of financial players, infrastructure providers and industry bodies.

The most pressuring deadlines are the (potential) LIBOR and Eonia cessation dates end of 2021. Regarding LIBOR, the Financial Conduct Authority (FCA) already confirmed they will not force panel banks to contribute after 2021. A majority of market participants expects that panel banks will stop contributing, since this just entails downside risks, and, accordingly, LIBOR will no longer be published. Further publication of Eonia (after 2021) will likewise depend on the Financial Services and Markets Authority (FSMA) enforcing EMMI, the relevant administrator, to do so.

On March 25, 2020, the FCA released a statement saying that "the central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet." However, there has been "an impact on the timing of some aspects of the transition programmes of many firms. Particularly in segments of the UK market that have made less progress in transition and are therefore still more reliant on LIBOR, such as the loan market, it is likely to affect some of the interim transition milestones". The FCA, Bank of England and the Working Group will further monitor the situation and will give an update, if needed or necessary.

Since the hybrid-EURIBOR was authorized as EU BMR-conformant and no expected deadline is communicated, the implication of Coronavirus on EURIBOR is probably the least.

In summary, we do not see the overall timeline for LIBOR being changed due to the Coronavirus situation. However, intermediary milestones such as the CCP transition (Eonia-€STR in June 2020 and EFFR-SOFR in October 2020) and the Q3 2020 milestone for the use of Sterling LIBOR in cash products may be affected.

## Soaring banking risk premiums

With the rising economic risks caused by the Coronavirus pandemic, it is only natural that the bank risk premiums rise. The traded spread between RFRs (€STR, SONIA and EFFR) and the respective LIBORs are soaring (see graphs). This will have some implication for the upcoming LIBOR transition:

- Increased default probabilities for banks, due to the recession. With the introduction of €STR and SOFR in collateralized derivatives contracts it might be relevant to consider backloading legacy OTC contracts, in order to reduce LGD in case the counterparty should default. Typical legacy trades are not secured using initial margin, in case of default there is real risk that the portfolio can be under- or over-collateralized effectively, increasing the LGD of the portfolio. During the Lehman event, such effects where very common.

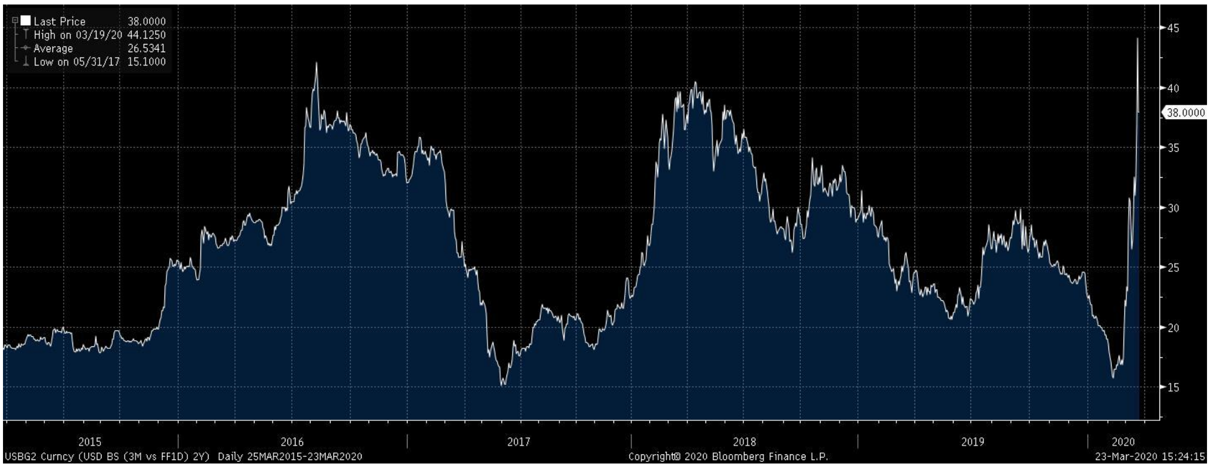
- Contracts using the ISDA 2018 Benchmarks Supplement to determine fallbacks and spread adjustments may cause actual value transfer between parties. The ISDA methodology is to use a 5-year median approach to determining the spread between LIBOR and the corresponding RFR. Assuming that LIBOR cessation is announced during 2021, no data from the ongoing Coronavirus crisis will be included in the compensation calculation. This may require a commercial agreement on the transition and not a statistical and legal approach to the topic.

- The Coronavirus pandemic highlights the differences between LIBOR and risk-free rates, since the risk-free rates do not compensate the increased borrowing premium incurred by banks. This will challenge both bank treasuries as well as end investors in the post-IBOR world.

*2yrs EUR Basis Swap Eonia vs. 3M LIBOR (Source: Bloomberg)*

*2yrs GBP Basis Swap Sonia vs. 3M LIBOR (Source: Bloomberg)*


*2yrs USD Basis Swap EFFR vs. 3M LIBOR (Source: Bloomberg)*



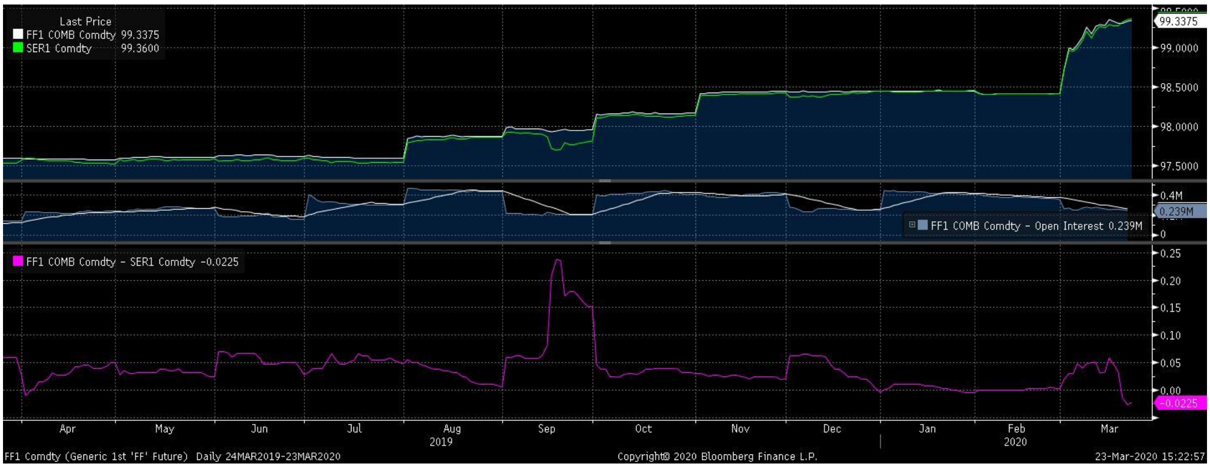

**Behavior of (secured) SOFR under Coronavirus stress**

The final thing to consider is how SOFR is reacting under stress.

Spiking SOFR-EFFR-spreads in September 2019, as underlying repo markets experienced significant stress, made some market participants question the behavior of the new benchmark overnight rate and LIBOR successor. However, recent spreads seem to indicate that SOFR and EFFR fluctuate nearly parallel with a small spread, even under severe market stress (see graph).

Please note that the relevant data is not to compare the daily fixings, but more the market expectations as expressed by the relevant futures.

*Comparison of one-month EFFR and SOFR futures (Source: Bloomberg)*




## Summary

In a nutshell, relevant regulatory decisions on deadlines are outstanding, however we are already seeing regulators reducing the immediate burden by postponing milestones accordingly. Despite this, the long-dated targets are still unchanged and now is not a time to ease up the focus on transition to the new RFRs.

With the widening risk premiums in the market, it may be time to reconsider both approaches to CSAs and counterparty exposure.

Further, the rising risk will no longer be compensated in the new floating rate benchmarks, giving a practical demonstration of the new basis risks to be managed.

Although controversial, with the turmoil in spreads and markets, it may become necessary to enter into commercial agreements on the LIBOR replacement, and not rely on the historical data driven approach as defined by ISDA.

As for SOFR, it looks like it is an adequate replacement for the current overnight rate. The dynamics of SOFR look very similar to that of EFFR (Fed Funds).