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LIBOR transition challenges

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Introduction

Although the London Interbank Offered Rate (LIBOR) is currently the most widely used interest rate benchmark and serves as a price reference for a broad range of financial instruments, the UK Financial Conduct Authority will stop supporting LIBOR at the end of 2021. According to the National Working Group (NWG) on Swiss Franc Reference Rates, the Swiss Average Rate Overnight (SARON) is the proposed replacement standard. The transition period poses several challenges for national and global market participants.

In December 2020 the Financial Market Supervisory Authority (FINMA) published guidance on the LIBOR transition in Switzerland. In this guidance, FINMA requires all supervised institutions (eg, banks, securities firms and insurers) to plan and initiate the necessary actions to implement the transition roadmap outlined therein with the goal to be fully prepared and operationally ready for the planned discontinuation of most LIBOR benchmarks by the end of 2021.

FINMA's new guidance is the latest in a series of recommendations for supervised institutions in connection with the LIBOR transition. It aims to ensure that financial institutions actively begin the replacement of most LIBOR rates with alternative reference rates (ARRs), particularly SARON for Swiss francs, and mitigate any operational risks relating to the transition. As such, FINMA mandated that all supervised institutions which have LIBOR-linked over-the-counter (OTC) derivatives outstanding had to sign the International Swaps and Derivatives Association (ISDA) 2020 Interbank Offered Rate (IBOR) Fallbacks Protocol by 25 January 2021. After this date, supervised institutions must enter only LIBOR-based derivatives contracts that provide for robust fallback clauses. The ISDA protocol is still open for adherence and enables the incorporation of revisions into legacy trades with other adhering counterparties on a multilateral basis. Bilateral templates, which enable parties to adopt the protocol bilaterally and thereby to amend the existing terms of their open transactions, are also available.

The same applies to all other financial arrangements. From 31 January 2021, according to FINMA's guidance, financial institutions must not enter any new transactions based on Swiss franc or euro LIBOR (and, if possible, also pound sterling, yen or US dollar LIBOR) that have a maturity date of January 2022 or later and contain no robust fallback provisions (known as 'tough legacy' contracts). In addition, financial intuitions must be operationally ready to enter financial arrangements based on ARRs such as SARON instead of LIBOR. From 1 July 2021 financial institutions must enter financial arrangements that refer only to ARRs, irrespective of the currency used (ie, irrespective of whether they refer to Swiss francs, euros, pound sterling, yen or US dollars). By the end of 2021 supervised financial institutions must not enter any new financial arrangements or contracts based on LIBOR. All transactions with variable interest rates in all currencies must be based on ARRs.

SARON

SARON is a rate that reflects the market conditions of overnight transactions in the secured Swiss franc money market and is administrated by the Swiss Stock Exchange (SIX). According to the rule book, SARON is calculated as a volume-weight average of transactions and binding quotes in the order book of SIX's electronic trading platform. It is continually calculated in real time and published every 10 minutes. However, a fixing is conducted three times a day at 12:00pm, 4:00pm and 6:00pm. The 6:00pm fixing, which is published immediately after the market closes, serves as a reference rate for derivative financial products and financial asset valuation.

According to the NWG, SARON is the proposed replacement standard. That is, compounded SARON will replace Swiss franc LIBOR as a term rate alternative. However, while SARON (and other ARRs) and LIBOR are

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both benchmarks, there are important differences between them:

- LIBOR is a forward-looking term rate, whereas SARON is a backward-looking overnight rate, which represents a different method.
- LIBOR is derived from quotes that are provided by panel banks' submissions, which are meant to be estimates of where they could borrow funds, whereas SARON is based on actual transactions.
- LIBOR is an unsecured borrowing rate and includes the panel banks' implied credit risk and a liquidity premium relating to the length of the interest period, whereas SARON includes no credit risk element or liquidity premium and is based on secured transactions.

When using a term reference rate (eg, three-month LIBOR) as a benchmark in a financial agreement, the interest payment amount due is known at the beginning of the interest period. This type of forward-looking term rate (known as an 'in advance' payment structure) reflects the expected level of interest for the next three months, equivalent to a sequence of expected overnight rates.

Conversely, using a compounded SARON, interest payments are the result of a daily compounded interest rate (ie, interest-on-interest). These rates are defined as backward-looking term rates (known as an 'in arrears' payment structure) and they reflect the realised level of interest over the past three months, equivalent to a sequence of realised overnight rates.

The forward-looking term rate could also potentially be derived from the SARON derivatives. However, the NWG assessed the feasibility of a forward-looking term rate based on SARON derivatives (eg, SARON swaps and futures) and concluded that a robust fixing is unlikely to be feasible, thus no forward-looking term rate for SARON will be determined and published. Unlike for certain other currencies, the calculation and publication of a synthetic rate for Swiss franc LIBOR is also not expected. However, SIX – as SARON's benchmark administrator – provides calculations for a compounded SARON for predefined periods in arrears beyond the overnight tenor. These SARON compound indices support the market for benchmarking and the determination of the observation period of a compounded SARON in financial products (eg, floating rate notes, overnight indexed swaps and futures).

The NWG has also published specific options on how a compounded SARON should be used as a benchmark in financial arrangements. For the domestic market, the NWG recommends the alternative shift and flooring of the compounded SARON. The observation shift mechanism weights the SARON rate according to the days in the observation period (ie, rather than the interest period), where the 'observation period' is defined as the period over which a compounded SARON applicable to a loan is calculated. The observation period begins a specified number of days before the first day of the interest period and ends the same number of days before the last day of the interest period. The specified number of days is the lookback period, which is often five business days. For cross-board transactions or where international consistency is important, the NWG recommends the use of lag methodology and the flooring of individual SARON values as an alternative.

Benchmark amendment standard documentation

Along with the documentation for derivatives contracts developed by ISDA, the Swiss Bankers Association has also published a corresponding amendment agreement for the Swiss Master Agreement (SMA) for OTC derivatives and supplemental interest rates, risk-free rates (RFRs) and Euro Overnight Index Average (EONIA) definitions. These will facilitate the IBOR transition and enable the trading of derivatives that reference EONIA and RFRs such as SARON, which will support the transition of legacy transactions to RFRs.

By signing the amendment agreement, counterparties incorporate for their open legacy transactions under the SMA the international standard fallback clauses of ISDA's IBOR Fallbacks Protocol. The same fallback clauses can also be incorporated into new LIBOR transactions by referencing the supplemental definitions in the respective transactional documentation. In addition, a Swiss law rate switch amendment agreement for syndicated loans based on the Loan Market Association's sample documents has been drafted and published. This aligns with the NWG's recommendations for the domestic Swiss market (ie, lookback with observation shift and lag as an alternative, a compounded SARON and a floor for a compounded SARON, if a floor is included).

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