HOULIHAN LOKEY

Dec. 2019

LIBOR Transition
Unique Perspectives of Asset Managers

INDEPENDENT VALUATION INSIGHTS

Executive Summary

Despite the fact that the Federal Reserve has been preparing for the demise of LIBOR[1] for five years, asset values do not yet reflect the disruptive effects of an event that is now likely only two years away. Seventeen large banks gathered in 2014 to choose a replacement and create a replacement path for LIBOR. However, it was not until the Financial Conduct Authority (FCA) made an announcement in 2017 that it became clear that LIBOR would cease and sophisticated market participants began to prepare in earnest. The Paced Transition Plan[2] was to be led by the banks and promulgated through industry groups, and eventually will come to rest on the front step of every firm with contracts referencing LIBOR.

Viewed through the lens of the ARRC,[3] the major lending and securities dealing banks would be the first to develop comprehensive transition programs and then advance that work into the broad ecosystem of borrowers, lenders, speculators, and hedgers. The ecosystem leaders also include clearinghouses and exchanges, vendors and system providers, industry groups, and regulatory/self-regulatory bodies. Now that the banks are progressed on the LIBOR transition, asset managers are the next significant group of market participants who will be asked by the banks, as their counterparties and trading partners, to begin replicating the same transition programs. The LIBOR transition cannot be a success for anyone unless it is executed by virtually everyone.

In this context, it is clear that this transition is not a regulatory mandate, but rather the largest and most complex voluntary market structure change ever in the fixed income markets. Each firm involved has a unique transition path and has a responsibility to evaluate its own risks, issues, and desired outcomes because the industry solutions are not comprehensive cures, only guidelines and suggestions.

Notes:

[1] London Interbank Offered Rate (LIBOR) is a rate administered by ICE and collected from expert submissions by 16 of the largest banks in the eurodollar markets across five currencies and four tenors. It embodies a set of characteristics and conventions and contains credit risk and term premium components.

[2] Paced Transition Plan refers to a document of the ARRC which considered all the new and modified inputs required to transition $300 trillion of LIBOR referencing contracts to a replacement index.

[3] Alternative Reference Rate Committee (ARRC) refers to 17 banks operating in the U.S. market were tasked with creating and selecting an alternative rate and advancing a plan to develop a broad implementation of that alternative rate. Not originally a committee to replace and discontinue LIBOR.

While asset managers can rely on the work of industry groups that have addressed a large set of the issues, and may be able to consider their transition which is smaller in scope than the banks, they still must address the same breadth of issues and remediations. For the most part, an asset manager's transition scope will be a direct function of the complexity of the business and will only be revealed by a thorough inspection of the entire front-to-back process.

LIBOR Is Ubiquitous, Pervasive, and Terminal

Ubiquitous

LIBOR is everywhere. It exists in almost every financial contract, risk model, payment system, and pricing mechanism. In all the places that it appears, risks and opportunities becomes an issue.

Pervasive

Deep, hidden, and intertwined, LIBOR is an underlying assumption in an overwhelming number of processes that have complex interactions throughout systems and organizations. It will not be sufficient to just identify and remediate every contract. The timing of all remediation will create risk because everything will not change at the same time. There will be no Big Bang, so to speak.

Terminal

LIBOR will cease to be an official benchmark because the current methodology, collecting expert submissions, is not compliant with the International Organization of Securities Commissions (IOSCO). LIBOR has been swimming upstream after $9 billion in fines and convictions of submitters. In response to the EU Benchmark Regulation, the FCA agreed to "no longer compel submission beyond the end of 2021." Though other events could accelerate or extend the publication of LIBOR, it is arguably already disqualified as an IOSCO-compliant benchmark.

Given the complexities surrounding LIBOR cessation, asset managers need to immediately undertake a transition program which identifies all the occasions of LIBOR in every contract, system, and process, and then plan to remediate every one of those instances, all in a robust and governed framework that strives to avoid the adverse selection that will occur as market participants act in their own self-interest.

Transition Programs—Designed for Asset Managers, Not Big Banks

While banks have developed large programs (hundreds of identified team members), an asset manager's programs will likely not have the same magnitude but will have the same breadth. The ARRC has published a practical implementation guide and the following list condenses that guide to seven steps. The core issue that creates the need for such a broad program is that LIBOR and its likely U.S. replacement, secured overnight financing rate (SOFR), are not the same thing—one is a forward looking multiday rate with credit risk and the other is an overnight rate with no credit risk or term premiums.

1. Establish Governance

Senior executive sponsorship and a robust governance framework are essential to managing the breadth and complexity of this transition. The issues are not likely to be housed in a single functional area, but rather, spread through multiple functions from front to back. Governance includes formal job descriptions and roles for a transition manager and associated staff (with at least part-time responsibilities) to fully staff and develop a program.

2. Identify Exposure

This is the full–scale review of every contract, system, model, and process for any reference to LIBOR. Exposures must be identified, catalogued, and have a risk metric attached.

3. Develop Strategy

Priorities, requirements, external solutions, client and enterprise communications, non-sequential conversion timing, risks and opportunities analysis, and a solutions discovery process are just part of the list that must be comprehensively considered and documented before remediation begins.

4. Manage Risk

Risk managers must identify and observe the metrics associated with the assets and processes in the firm to monitor potential increases in risk.

5. Choose Solutions

There will be many alternatives for actual, product-by-product remediation. Bilateral negotiations, swapping assets, and changing hedge methods are just a few of the alternatives. Product teams will need to evaluate the best way forward for both new transactions and legacy assets. However it will need to happen consistently with market activity, vendor and technology changes, industry group recommendations, and more.

6. Implement and Test

Implementation follows and is likely to be where the unforeseen problems and risks are exposed. The more time for this step, the better. Document modification and renegotiation happens in this step.

7. Prepare for Litigation

The emphasis on governance, program, and documentation is to anticipate and avert the possibility of adverse outcomes due to consumer and class action litigation, which is highly likely to occur after the cessation of LIBOR.

Timing, Certainty, and Pending Cascade of Events

LIBOR transition is a voluntary market change among all participants. Though highly encouraged by global regulators and the official sector, it does not have the certainty and defined timetable of legislation or regulatory mandate. It remains subject at every turn by existing contract provisions and the willingness of participants to determine self-interest and take action to amend and remediate.

However, there is a clear path which is being advanced domestically by the Federal Reserve, the Commodity Futures Trading Commission, the Treasury's Financial Stability Oversight Council, and the Securities and Exchange Commission; and globally by the Financial Conduct Authority and the Bank of England, the Global Financial Markets Association, and the Financial Stability Board's Official Sector Steering Group. The advancement also includes industry groups, such as the International Swaps and Derivatives Association (ISDA), the Loan Syndications and Trading Association (LSTA), the Structured Finance Industry Group (SFIG), and commercial real estate (CRE). This path advocates the creation of conventions and protocols for new transactions to reference SOFR and to create and adopt trigger and fallback[4] and protocol and supplement[5] language for legacy transactions also referencing SOFR. All of these work through the guidance and coordination of the ARRC and its many working groups.

Notes:

[4] Trigger and fallback indicates documentation concepts that provide clarity in the event that LIBOR discontinues. Triggers are the methodology to determine cessation and fallback is the method that determines the replacement rate.

[5] Supplement and protocol is ISDA terminology for the documentation of derivatives. Supplement is the document which amends the ISDA Master Agreement definitions (which currently do not contemplate the terminal nature of LIBOR). Once amended by ISDA, all participants reference this standard. Protocol is a bilateral agreement to apply the supplement to existing (legacy) trades. This must be adopted by each counterparty before it becomes effective.

Critical Events for 2020—the Cascade

Derivatives: Early in 2020 (or sooner) ISDA will release its supplement for new trades which will contain new triggers and fallbacks, and shortly thereafter will embark on a protocol for legacy trades. These changes will codify the mechanism for every LIBOR derivative to reference SOFR upon cessation of LIBOR and will begin to be bilaterally adopted at clearinghouses, dealer banks, and their customers. ISDA will also begin publishing the Spread Adjustment[6] which will be added to SOFR to make it equivalent to LIBOR.

This combination of settled documentation and observable spread will increase trading in new issue SOFR notes, derivatives, and futures causing liquidity to be removed from the LIBOR referencing markets. It will also give regulators and risk managers the strong incentive to advocate for conversion of entire legacy portfolios to SOFR since valuations will now be reflective of observable inputs.

Cash Products: During the same time, LSTA for loans, SFIG for asset-backed security (ABS), and CRE for commercial loans will all have settled their proposed new issue language for triggers and fallbacks. Given that the originating banks for syndicated loans are largely highly regulated, there will be self-interest in adopting settled language for all new issues. Bilateral loan markets and new issue ABS will follow suit as investor acceptance and issuer reluctance are both moderated by increased liquidity.

Small "Big Bang": On October 16, 2020, clearinghouses CME and LCH, in a coordinated activity, will transition the PAI rate to SOFR. Technical details aside, this means that valuations of derivative positions and the interest payment on collateral posted to the exchange will all be on a SOFR curve. This generates genuine and longer-dated risk that adds to the pressure to execute genuine risk transfer in SOFR-referencing derivatives.

Though it may appear that 2020 is the year of the derivative transition to SOFR, cash products of all types will be close behind for two significant reasons: regulatory push and tipping point FOMO (fear of missing out). In supervision meetings, regulators are already asking firms to explain the risk management implications of executing new issue and new derivative trades without improved fallbacks for tenors exceeding two years. As liquidity and tenors in SOFR increase, regulators will begin asking about the risk management implications of having enormous legacy risk portfolios when there is an available path to conversion.

Notes:

[6] Spread Adjustment is an ISDA methodology for determining the number of basis points that will be permanently added to SOFR in each tenor of LIBOR (one-month, three-month, six-month, and 12-month) for all LIBOR-referencing trades governed by the supplement and fallback. This adjustment is not relevant for new SOFR trades. This adjustment will be third-party calculated daily and published widely so that the market has an observable price for cessation event valuation.

APPENDIX: Houlihan Lokey's LIBOR Transition Advisory Engagement Framework

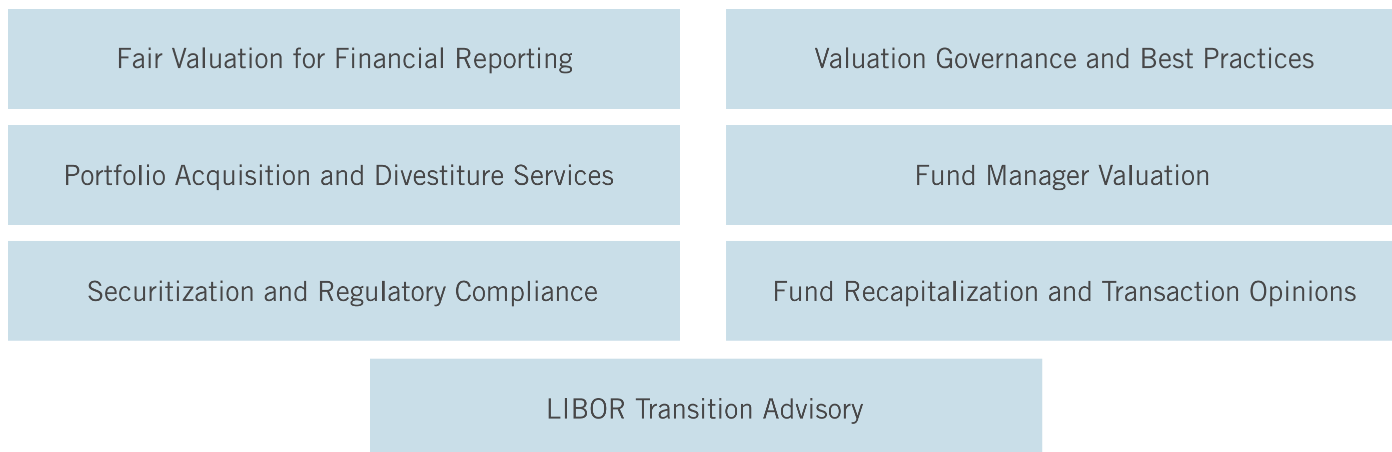
Action	Expression	Manifestation
Activate	**Discipline and Clarity** Activate or establish your transition program by extracting your key issues from the complexity and uncertainty around the topic	▪ Workshops for teams and leaders to inform and set knowledge levels ▪ Risk and issue identification meetings ▪ Gap analysis versus expected market events ▪ Program design—outright or advisory ▪ Information and analysis sessions for senior management
Accelerate	**Direct Engagement** Accelerate your program with authentic rates markets experience and expertise	▪ Pricing and structuring considerations for new products ▪ Buy, sell, and amend strategies on legacy products ▪ Mechanics and impacts of moving to backward looking overnight versus forward looking term rates ▪ Evaluate fallback changes across all asset types and jurisdictions ▪ Identify springing basis risk from nonsimultaneous conversion ▪ Transfer pricing policies
Ascertain	**Quantitative Discovery** Ascertain and calculate risk and potential outcomes	▪ Portfolio and business level risk quantification relative to defined scenarios ▪ Model review and remediation ▪ Transition heuristics for nonsimultaneous conversion among risk categories ▪ Valuation impact analysis
Augment	**Skilled Execution** Augment your teams to accelerate program components	▪ Contract review ▪ Contract negotiation and amendment ▪ Advise on document handling process/technology
Anticipate	**Governance Support** Anticipate the needs of customers, management, shareholders, boards, and regulators	▪ Write or advise on communications to all parties; forecast results of policy ▪ Prepare reports to boards or senior management on preparedness or achievements ▪ Prepare regulatory response documents
Avert	**Forestall Adverse Outcomes** Avert negative selection, unintended consequences, and litigation	▪ Program outcomes validation and benchmarking ▪ Monitor and analyze industry and market developments relative to program milestones ▪ Advise on litigation prevention strategy (safe harbors/benchmarking) particularly relative to bilateral or consumer debt ▪ Generate audit materials

About Portfolio Valuation and Fund Advisory Services Practice

Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our (i) strong reputation with regulators, auditors, and investors; (ii) private company, structured product, and derivative valuation experience; and (iii) independent voice. We have valued illiquid assets on behalf of hundreds of hedge funds, private equity firms, financial institutions, corporations, and investors. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries along with our real-world transaction experience and market knowledge from our dedicated global Financial and Valuation Advisory business.

Awards

Our Service Areas



Contacts

David Wagner
Senior Advisor
Financial and Valuation Advisory
DWagner@HL.com
212.497.7984

Dr. Cindy Ma
Managing Director
Head of Portfolio Valuation and
Fund Advisory Services
CMa@HL.com
212.497.7970

HOULIHAN LOKEY

ABOUT HOULIHAN LOKEY

Houlihan Lokey is a leading advisor to many of the world's most prominent financial institutions and specialty finance companies that rely on the firm's reputation with auditors, regulators, and investors; the firm's valuation and accounting experience with public and private companies, structured products and derivatives; and the firm's independent voice. Houlihan Lokey has valued assets on behalf of hundreds of hedge funds, private equity firms, financial institutions, corporations, and investors and provides timely and comprehensive accounting advice to its clients for their most complex transactions. The firm rapidly mobilizes the right team for the job, drawing on its expertise in a wide variety of asset classes and industries along with its real-world transaction experience and market knowledge from the firm's dedicated global Financial and Valuation Advisory business.

Houlihan Lokey is a trade name for Houlihan Lokey, Inc., and its subsidiaries and affiliates, which include those in (i) the United States: Houlihan Lokey Capital, Inc., an SEC-registered broker-dealer and member of FINRA (www.finra.org) and SIPC (www.sipc.org) (investment banking services); Houlihan Lokey Financial Advisors, Inc. (financial advisory services); HL Finance, LLC (syndicated leveraged finance platform); and Houlihan Lokey Real Estate Group, Inc. (real estate advisory services); (ii) Europe: Houlihan Lokey EMEA, LLP, and Houlihan Lokey (Corporate Finance) Limited, authorized and regulated by the U.K. Financial Conduct Authority; Houlihan Lokey S.p.A.; Houlihan Lokey GmbH; Houlihan Lokey (Netherlands) B.V.; Houlihan Lokey (España), S.A.; and Houlihan Lokey (Corporate Finance), S.A.; (iii) the United Arab Emirates, Dubai International Financial Centre (Dubai): Houlihan Lokey (MEA Financial Advisory) Limited, regulated by the Dubai Financial Services Authority for the provision of advising on financial products, arranging deals in investments, and arranging credit and advising on credit to professional clients only; (iv) Singapore: Houlihan Lokey (Singapore) Private Limited, an "exempt corporate finance adviser" able to provide exempt corporate finance advisory services to accredited investors only; (v) Hong Kong SAR: Houlihan Lokey (China) Limited, licensed in Hong Kong by the Securities and Futures Commission to conduct Type 1, 4, and 6 regulated activities to professional investors only; (vi) China: Houlihan Lokey Howard & Zukin Investment Consulting (Beijing) Co., Limited (financial advisory services); (vii) Japan: Houlihan Lokey K.K. (financial advisory services); and (viii) Australia: Houlihan Lokey (Australia) Pty Limited (ABN 74 601 825 227), a company incorporated in Australia and licensed by the Australian Securities and Investments Commission (AFSL number 474953) in respect of financial services provided to wholesale clients only. In the European Economic Area (EEA), Dubai, Singapore, Hong Kong, and Australia, this communication is directed to intended recipients, including actual or potential professional clients (EEA and Dubai), accredited investors (Singapore), professional investors (Hong Kong), and wholesale clients (Australia), respectively. Other persons, such as retail clients, are NOT the intended recipients of our communications or services and should not act upon this communication. This email is an advertisement from Houlihan Lokey. To opt out from receiving marketing communications from Houlihan Lokey and to manage your preferences in relation to the communications that Houlihan Lokey sends you, click here. Written inquiries can be sent to 10250 Constellation Blvd., 5th Fl., Los Angeles, CA 90067, or you may reach us via our contact page.