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LIBOR Transition: CFO/CRO Perspective

Executive Summary

The LIBOR transition has arrived at the doorstep of senior managers across the broad range of market participants whose businesses reference this soon-to-cease benchmark. CFOs and CROs have concerns in three areas: disclosure and examinations, valuation and risk metrics, and costs and performance.

Regulators are announcing examination priorities, making information requests, and warning that inadequate preparation is not acceptable. While the U.K.'s Prudential Regulation Authority is leading the charge in conduct accountability, the U.S. will see similar concepts play out in litigation by aggrieved parties to transition decisions. Simply having a light regulatory framework is not a guarantee of safe harbor as the regulatory reach pushes past the regulated entities and into the nonregulated.

Moving beyond the identification of headline numbers, CFOs and CROs are now responsible for analyzing and calculating their organization's exposures to the cessation of LIBOR in metrics of risk and costs. This exercise is a challenge for organizations. Many of them have never had to address such a pervasive market structure change not driven by law or regulation. Senior managers are now just realizing the effort required to understand all potential cessation paths and calculate the impact on valuation and risk. Ultimately, CFOs and CROs will be responsible for disclosures about the transition (including these metrics) to markets and investors, as well as in the responses to regulatory information requests that are appearing all over the official sector.

Senior managers will either have to address or be cognizant of granular issues as program managers work through the volume of documents with disparate language, extract the data and logic, apply scenarios, and calculate potential changes in valuation and risk. Balancing expediency and cost with accuracy will require familiarity with the choices in the process. Ultimately, the disclosures and reporting will rely on that accuracy and the defense against potential litigation will begin with the methodology applied to determine the organization's idiosyncratic risk profile. That profile will drive the decisions incorporated into a firm's LIBOR transition plan, and that plan will determine how each interested constituent's LIBOR instrument should be remediated, renegotiated, replaced, or otherwise managed.

Some of the effects of the transition will be visible after cessation, in value transfer from automatic mechanisms and springing risks that occur due to differences in timing between different instruments. In addition to the potential for value transfer and springing risks, the transition will have costs. These efforts to bring all LIBOR-

based instruments to a new reference rate will have cost impact throughout the organization. The CFO office in particular may be responsible for estimating and controlling these costs through a disciplined LIBOR transition program. The transition team will also be responsible for creating a process that reduces the opportunity for conduct risk and the associated threat of suit, particularly for businesses with asymmetry between themselves and customers.

By the end of 2020, organizations with successful transition programs will have established a competitive advantage in the market through a combination of defensive, offensive, and cost reduction strategies.

Disclosure and Examinations

The SEC, OCC, PRA, Federal Reserve, and New York State Department of Financial Services (NY DFS) have all announced heightened exam priorities in regard to the LIBOR transition. While these exams are only directed at the regulated entities, the effect extends beyond. As an example, the recent NY DFS request letter[1] was directed at a handful of larger investors acting as limited partners. Those LPs passed on the request to unregulated GPs to be able to comply with the terms of the request. GPs then had to develop statements, plans, disclosures, and provide the same materials to LPs.

In the recent SEC Office of Compliance Inspection and Examinations (OCIE) report on 2020 priorities, OCIE warned that it will be reviewing firm's preparedness and disclosures regarding readiness and the transition effects on investors. This includes specifics on the use of and operational exposure to LIBOR, and their client's exposures. Many areas of concern were explicitly identified, including contracts, benchmarks/indices, risk models, and client reporting. They warned that insufficient preparation could cause harm to retail investors and significant legal, compliance, economic, and operational risks for registered investment advisors and investment companies.

The Office of the Comptroller of the Currency (OCC) recently announced increased oversight into the LIBOR transition for all its regulated banks—evaluating bank awareness and preparedness. OCC suggests that the LIBOR transition may increase operational, compliance, and reputational risks associated with moving clients to a new rate, or new product offerings and services that are benchmarked to a new alternative rate. Assessment of these risks should include analysis of customer impact, repapering contracts, updating system applications, revising and testing models, and having the appropriate fallback language and disclosures to clients.

The U.K. Prudential Regulation Authority (PRA), part of the Bank of England, just released aggressive new timetables for the cessation of GBP LIBOR usage across all products. This action is an easier implementation since SONIA, the replacement rate, is an operational market rate and the single regulator governs almost all financial market participants. They specifically advised asset manager CEOs that they were compiling data on the firm's business models and exposure to LIBOR in the January 20 letter.

All of these regulatory requests and statements, as well as investor diligence, make it clear that the obligation to disclose has risen beyond a simple statement and now requires disclosure that describes risks, remediations, plans, and governance.

Valuation Impacts and Risk Metrics

The challenge for the CRO/CFO office is to create an inventory of risks, a set of metrics for those risks, and a remediation plan with potential costs which is robust enough to be used for regulatory responses, investor diligence requests, and owner disclosures. Depending on the complexity of the firm, this effort may be conducted

Source:

[1] "Industry Letter: Request for Assurance of Preparedness for LIBOR Transition." *DFS.NY*, December 23, 2019, https://www.dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf.

by hand over a small number of transactions, or with the aid of machines for firms with multiple vehicles, internal asset-liability matching, multiple contract types, and a large number of overall transactions. The analysis of what happens when LIBOR ceases requires an understanding of documents, events, and the flow of decisions embedded across all products or contracts.

A resolution might be to approach your inventory as a collection of unstructured data and ascertain its structure—or ontology.

"An **ontology** is a formal description of knowledge as a set of concepts within a domain and the relationships that hold between them ... However, unlike taxonomies or relational database schemas, for example, **ontologies** express relationships and enable users to link multiple concepts to other concepts in a variety of ways."[2]

Steps	Description	Result
Inventory risks and collect documents	Establish transition program with staffing and governance; second action is inventory	Establish a basic workflow that can be interrogated, evidenced, and audited
Ingest and Parse	Using a combination of natural language processing, artificial intelligence, and human experts, read all language and group everything related to LIBOR	Entire document is stored, parsed, and prepared for structured query on this topic or any other in the future
Model structured data	Build a model that includes conditional and definitional ambiguity	This exposes the waterfall of fallbacks to the valuation and risk calculations for a range of events
Incorporate static data	Just like a normal pricing—all terms, amortizations, etc., from a third party source	Prepares for initial calculations and scenario calculations
Determine LIBOR cessation scenarios	In conjunction with advisor, create the two or three real-world event sequences that are of concern	While all outcomes could be priced, most CRO/CFO offices utilize scenarios as a probability input to focus the results
Evaluate scenarios against dynamic market data	Each scenario will determine changes in pricing inputs	Applies specific curves or spread assumptions
Calculate valuation and risk outcomes	Creates price changes and identifies risk that did not exist prior to event	Result is determined by scenario in points per issue and changes in DV01

Source:
[2] "What are Ontologies." *Onotext*, https://www.ontotext.com/knowledgehub/fundamentals/what-are-ontologies/. Accessed February 26, 2020.

The Program Management Office will use this output to create priorities for remediation; Portfolio Management will identify assets to buy or sell; Operations will identify potential impacts on payments, settlements, and systems. The overall result will also create digitized libraries of documents ready to respond to future market structure changes, such as negative rates, rating downgrades, reps and warranties, ESG concepts, trustee actions, and other noneconomic terms. Applicable document types could include: loans, offering memos, prospectus, MRA/GMRA, ISDA Master and Schedule, confirms, funding agreements, and amendments.

Costs and Performance

The CFO/CRO office will also be responsible for an estimate of costs and impacts on portfolio performance. Once the digitization and modeling described above is completed, these estimates will have greater granularity and accuracy. The overall financial services industry cost for the LIBOR transition has been estimated at more than $200 billion.[3] Boards, owners, and investors will begin asking this year about the cost impacts. Depending on the pervasiveness of LIBOR in the organization and the number of remediations of systems, models, and documents, any one firm will incur nontrivial costs in internal or external resources. While vendors are developing software upgrades for these replacement rates, they will be delivered as new versions which could require multiple version upgrades prior to the version ready for the replacement rate.

Performance

The analysis described above will inform multiple areas of the firm about possible courses of action grouped into offensive, defensive, and cost reduction strategies.

Offensive Example

A firm chooses to buy or sell specific securities based on the known adverse or beneficial results of LIBOR cessation. If a bond is known to revert to last LIBOR and rates are expected to decline, the bond should trade up in price. If a loan is known to convert to Prime and the borrower is not suited to refinance, then that loan should increase in price. Other scenarios are possible and a full analysis of the document language and market conditions will create a list of offensive strategy candidates either in the portfolio or in the market. These strategies may also include legal action to preserve advantageous rate changes or intercreditor cash flow changes.

Defensive Example

Same choices but opposite actions. If a bond converts to last LIBOR in an upward rate expectation, the most prudent choice may be to sell that bond today before its value is impacted. For a loan, it may mean to aggressively pursue bilaterals to amend to forestall the risk of refinance even if it may mean fielding requests for covenant changes.

Cost Reduction Example

By bucketing the transition issues with large numbers of contracts versus fewer, or critical funding agreements versus less used, it may be easier to identify efficiencies from external service providers and concentrate scarce internal resources on specific high priorities or bespoke documents.

Source:
[3] Federal Reserve

Litigation Effects

Potential litigation is greatest in this transition where information asymmetries exist, such as with consumer assets, the trustee and calculation agent community is aware that these offensive and defensive strategies will put them in the crosshairs of one side or the other. While not an unusual position, it is an area without precedent or safe harbor and at a minimum will complicate the timetable of a LIBOR cessation and increase the uncertainty of outcome. All this will impact valuations soon.

Conclusion

Successful transition before the end of 2020 will be a competitive advantage for firms with a CFO/CRO office that has begun preparations and has developed strategies ahead of the inevitable valuation changes that will affect assets simply from the expectation of the impact of the LIBOR transition.

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, market 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

Action	Expression	Manifestation
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

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