

Good-bye Libor: What you need to know to be prepared

UniCredit Research Webcast

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Corporate & Investment Banking

Libor transition

Why moving away from Libor (the pandemic has not affected or delayed this decision !)

Euribor is here to stay

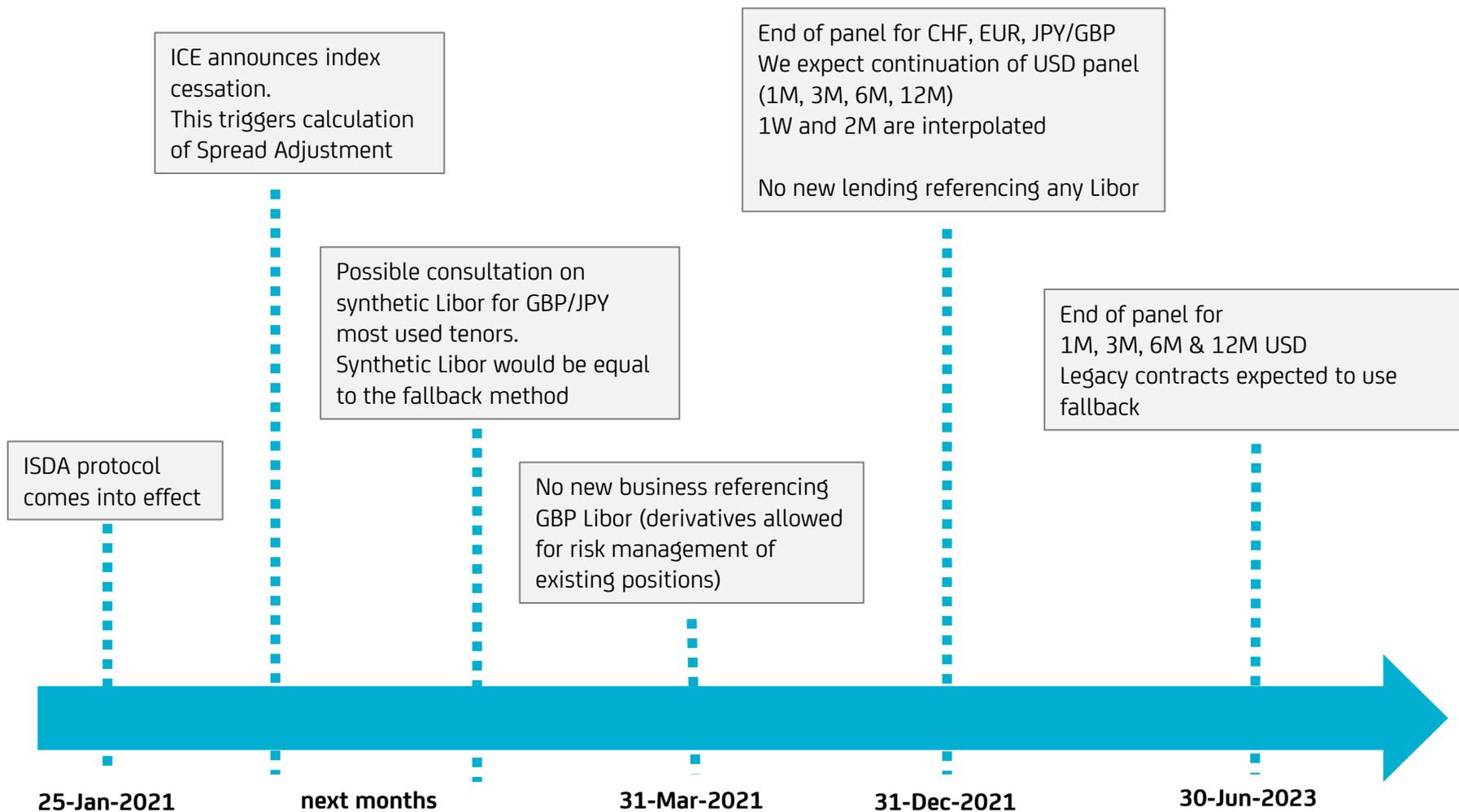
Libor transition: the timeline ahead

The issue of legacy contracts

Risk-free rates as a replacement for Libor



Libor transition: the timeline ahead



A key issue arising from Libor transition: legacy contracts

Legacy contracts: how to manage contracts referencing Libor that will expire after the cessation of Libor?



Derivatives (exchange-traded, OTC)
Some exceptions:
non-linear derivatives/derivatives used to
hedge other contracts



ISDA protocol/LCH



Tough legacy (bonds, loans, cross-
border contracts)

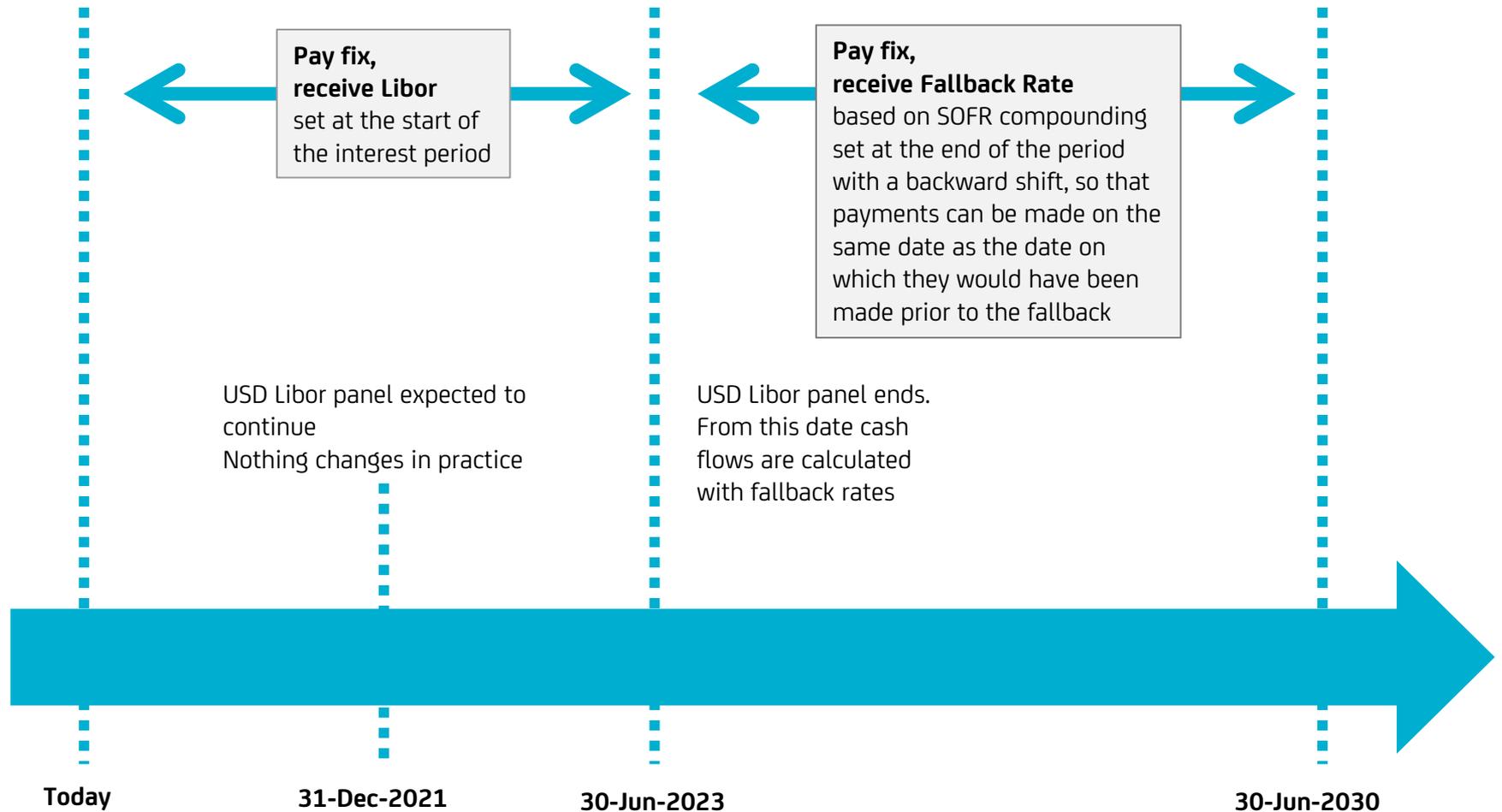


- USD Libor panel will likely stay in place until June 2023 to favor run-off (no new business will reference it)
- Ah-hoc legislation/BMR review/statutory replacement
- Synthetic Libor

Active management by counterparties strongly advised – Firms should proactively remove Libor dependencies from their contracts before the end of 2021 to reduce uncertainty and risk



What if I have a 10Y swap (paying) in USD entered in June 2020?



How new contracts will work

New contracts: Overnight Risk Free Rates very likely to be the new standard



RFR are overnight rates: need to use compounding in arrears or backward-looking (avg. of past periods)
Term rates are "under construction" (ICE launched 1M, 3M 6M & 12M term rates)
Term rates would be the preferred option for some products (e.g. retail products, trade finance)



RFR do not embed bank funding cost, while Libor does



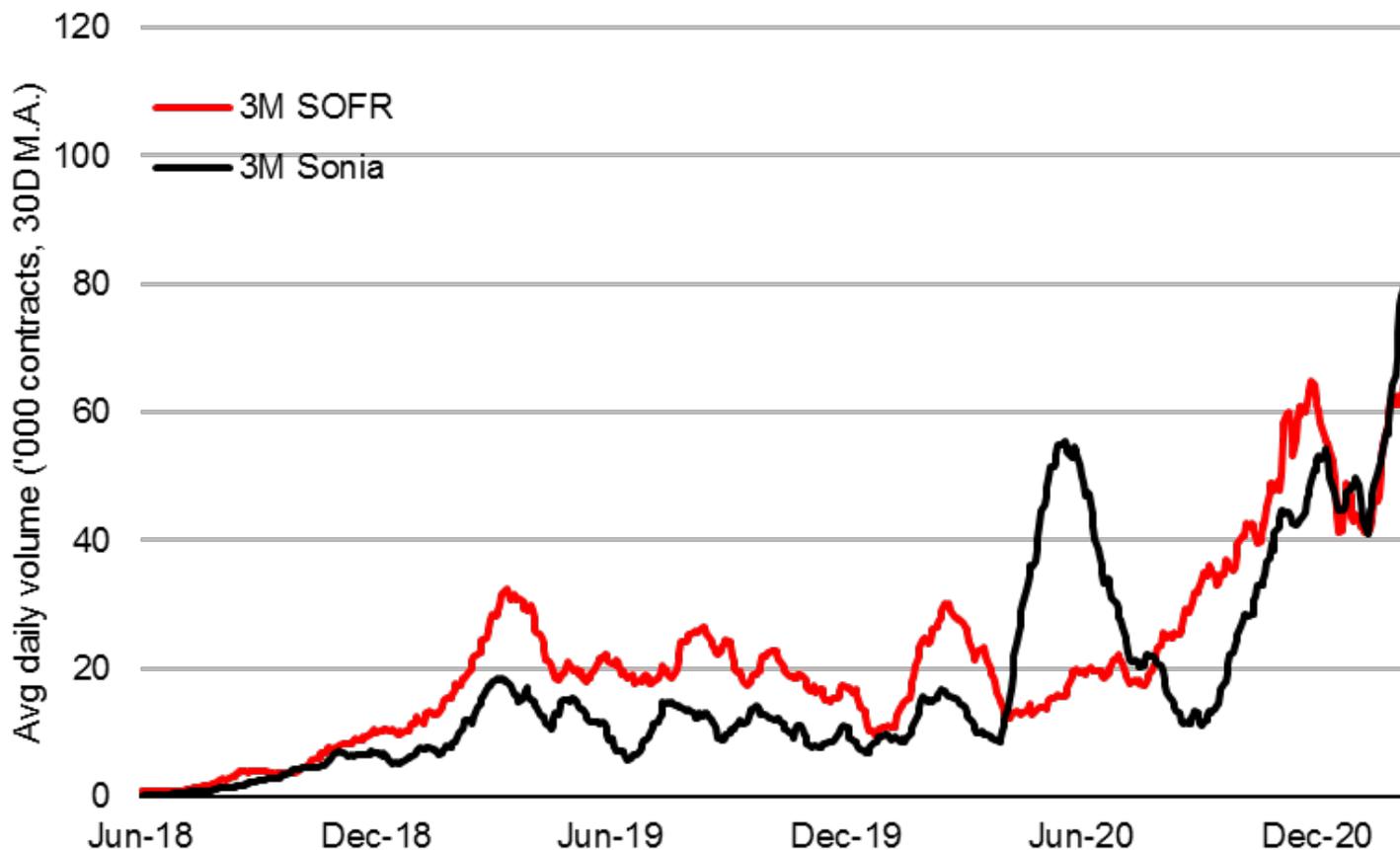
Different products may require different conventions for averaging RFR (simple vs. compounding, lookback etc). This may complicate hedging



Possible alternatives (ICE bank yield index for example)
Mind the gap: RFR already have a growing derivative market!



SOFR and SONIA futures: the market is growing



...but derivatives trading is still mostly in Libor. RFR derivatives trading has more to go !



Once Libor contributions end, legacy contracts will use fallback rates

$$\text{Fallback rate} = \text{Adjusted Risk-free Rate} + \text{Spread adjustment}$$



Average of the relevant risk-free rate (SOFR, SONIA, TONAR, SARON, €STR) over the appropriate horizon

Calculated as compounding in arrears

Need for lookback, lockout or shift

The ARFR is updated every day to reflect the level of short-term rates



Accounts for bank related credit-spread component present in Libor

Calculated as the median over a five-year period of the spread between the relevant Libor tenor and the RFR

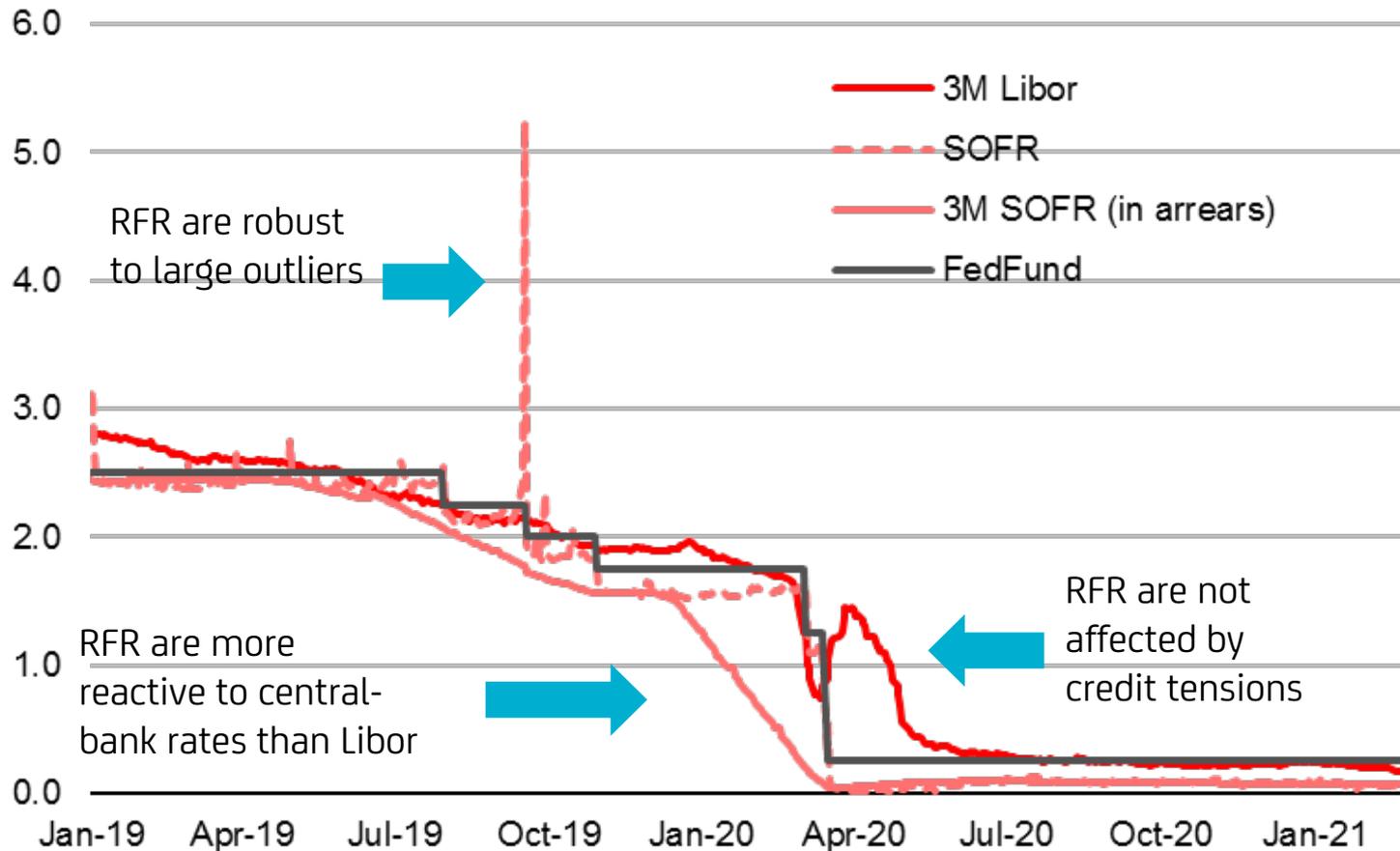
The spread adjustment becomes fix upon Libor cessation event (potentially well before the end of Libor panel)



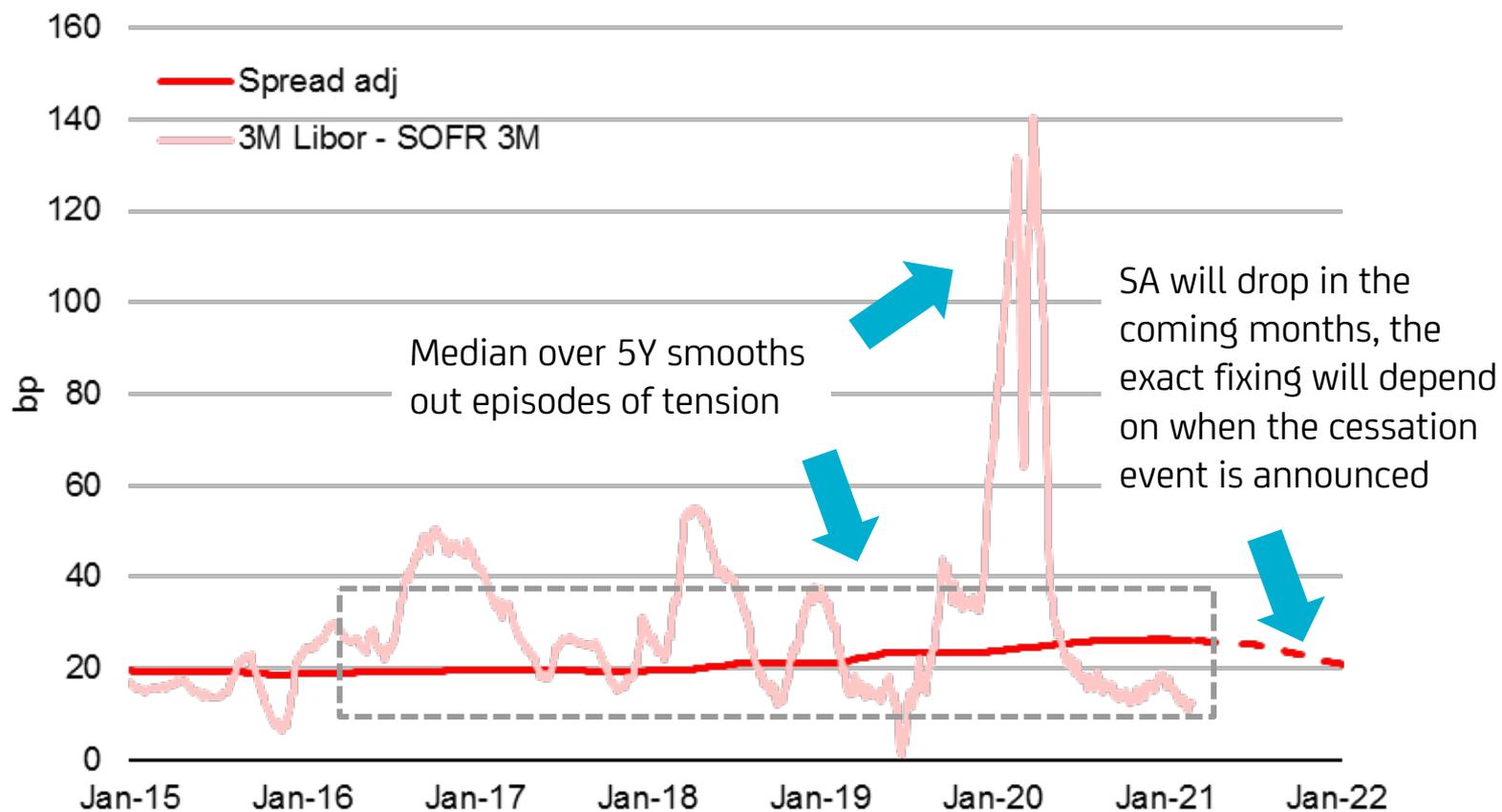
Luckily we do not need to calculate the fallback: Bloomberg does it already



How do RFR in arrears behave in practice? A lesson from COVID-19



Spread adjustment: how it works, where we stand



Conclusions

Libor transition is at an advanced stage, no new business referencing Libor after the end of 2021.

Addressing legacy contracts will be an issue. The golden rule is to seek active transition whenever possible.

Libor will be replaced by risk-free rates, which are based on overnight rates.



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