INSTITUTE OF INTERNATIONAL FINANCE

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# LIBOR Transition for Emerging Market Countries

## Risk management from the market's perspective

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# Introduction

- LIBOR set to be phased out by 2022 - UK FCA affirmed that banks would no longer be required to submit estimates after 2021

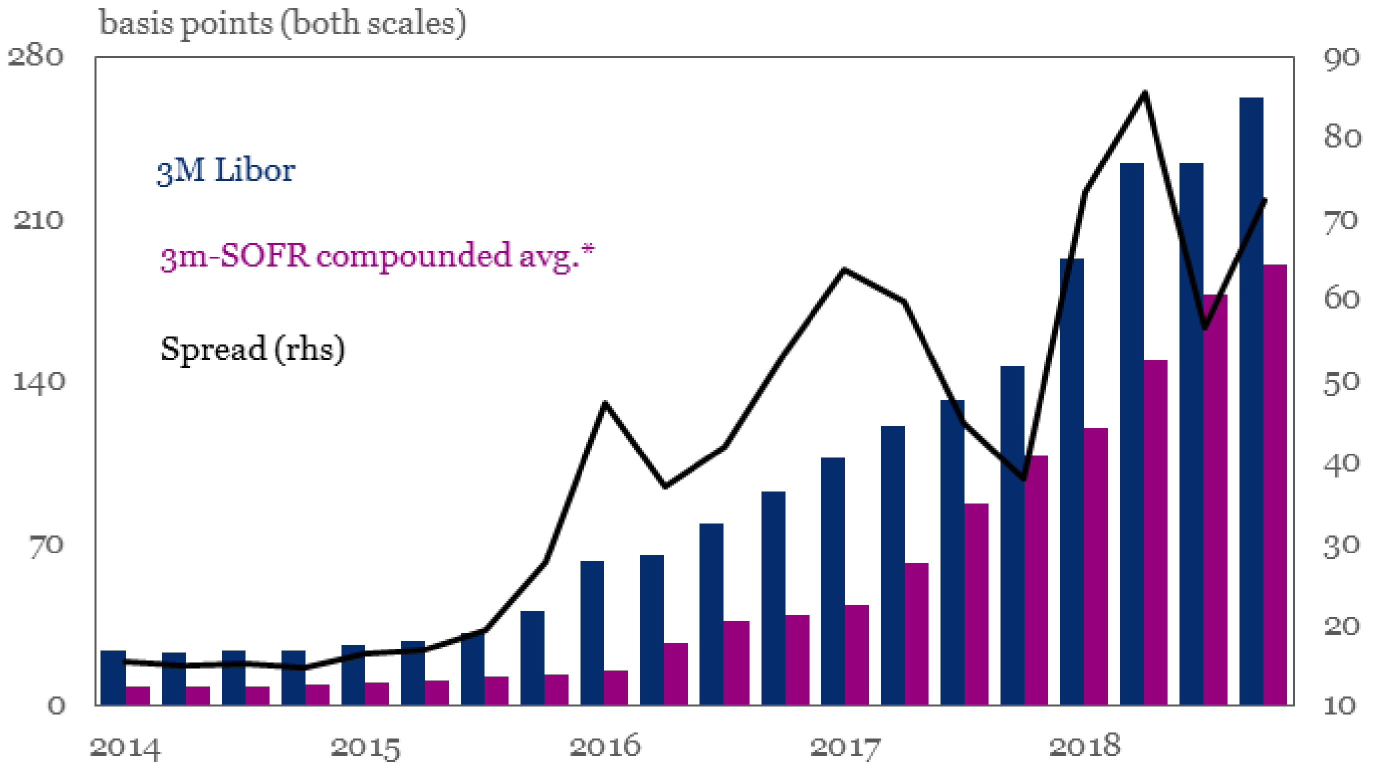
- New risk-free reference rates (RFRs) have been selected:
  - U.S. → SOFR (Secured Overnight Financing Rate)
  - U.K. → SONIA (Sterling Overnight Index Average)
  - Japan → TONA (Tokyo Overnight Average Rate)
  - Eurozone → ESTER (European Short Term Euro Rate)
  - Switzerland → SARON (Swiss Average Rate Overnight)

- Differences between LIBOR and the new reference rates (RFRs) can generate considerable financial discrepancies.

- Over 80% of contracts referencing USD LIBOR as of end-2016 will mature by 2021.

# Introduction

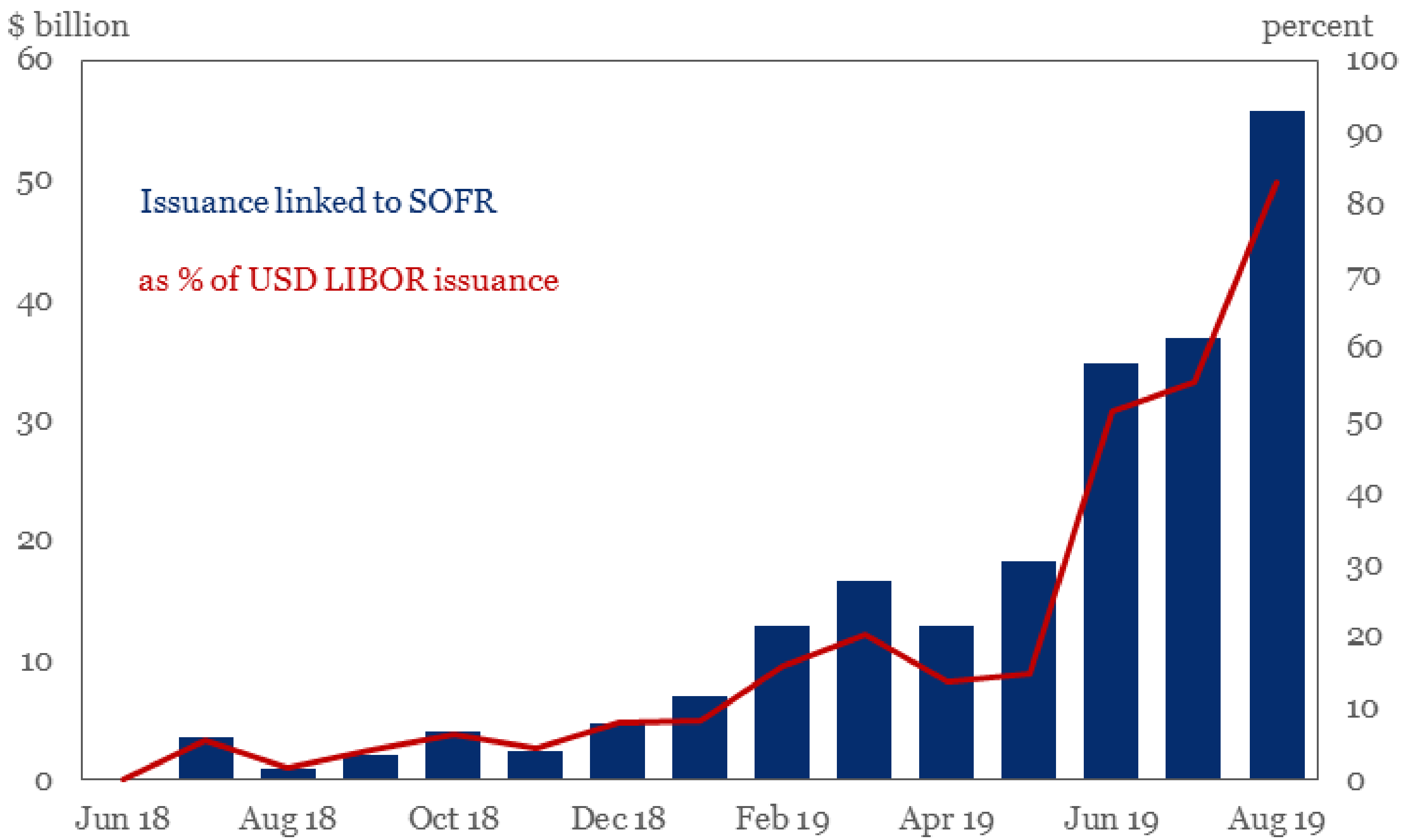
**Transition risk: significant discrepancies between 3M Libor and new SOFR**




*Source: Bloomberg, IIF; 3-month SOFR rate calculated based on geometric avg. of the overnight rate over a 3-month period of backward-looking basis. In the absence of a published rate, we used EFFR as proxy.*

# Introduction

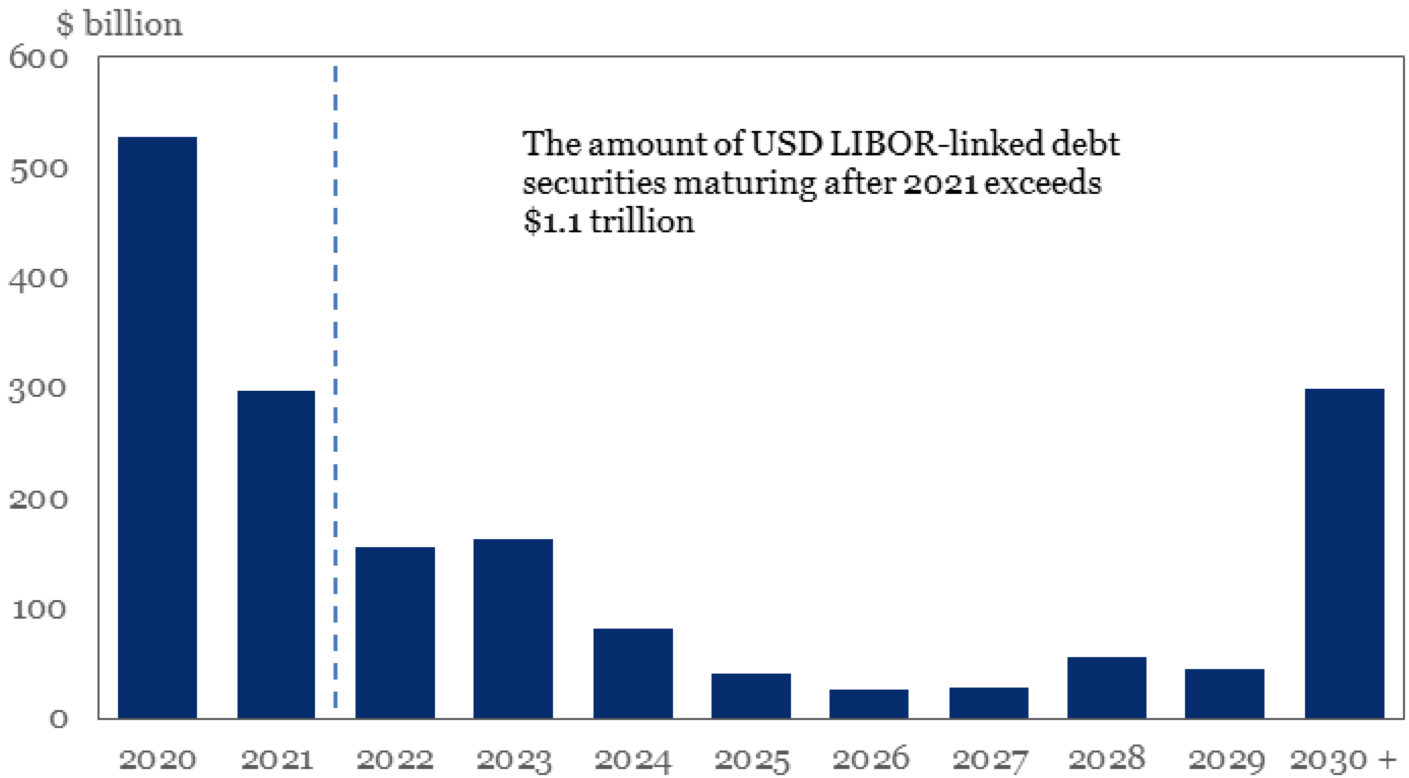
LIBOR transition in progress: issuance of debt securities linked to SOFR is picking up




*Source: Bloomberg, IIF*

# Introduction

**Transition risk: a lot of LIBOR-linked debt securities will mature *after* the phase-out deadline of 2021**




*Source: Bloomberg, IIF*

# Introduction – important issues

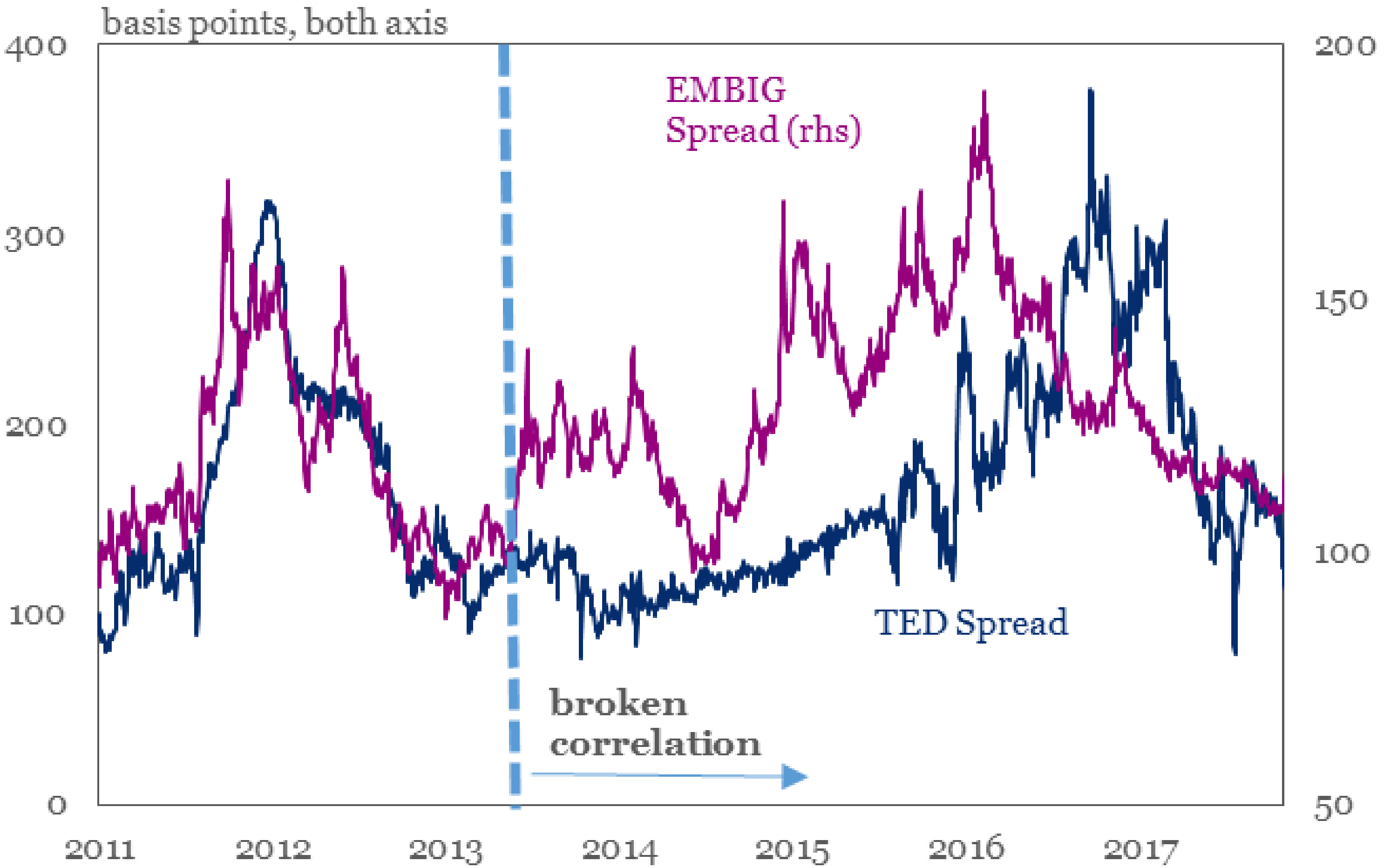
- Appropriate "fallback" language—legal provisions in a contract that apply if the underlying reference rate is discontinued or unavailable—is crucial.

- Term structure is one important challenge given different LIBOR tenors vs. the new O/N benchmark rates, highlighting the need to build the reference curve from O/N to term rates.

- Segmentation is another issue to be addressed. Although efforts have been coordinated across jurisdictions, each new reference rate also reflects local market characteristics and preferences. Reconciling cross-country differences is particularly important for international transactions involving EM governments and companies.

# EM concerns

USD LIBOR has long ceased to be a barometer for EM USD credit risk



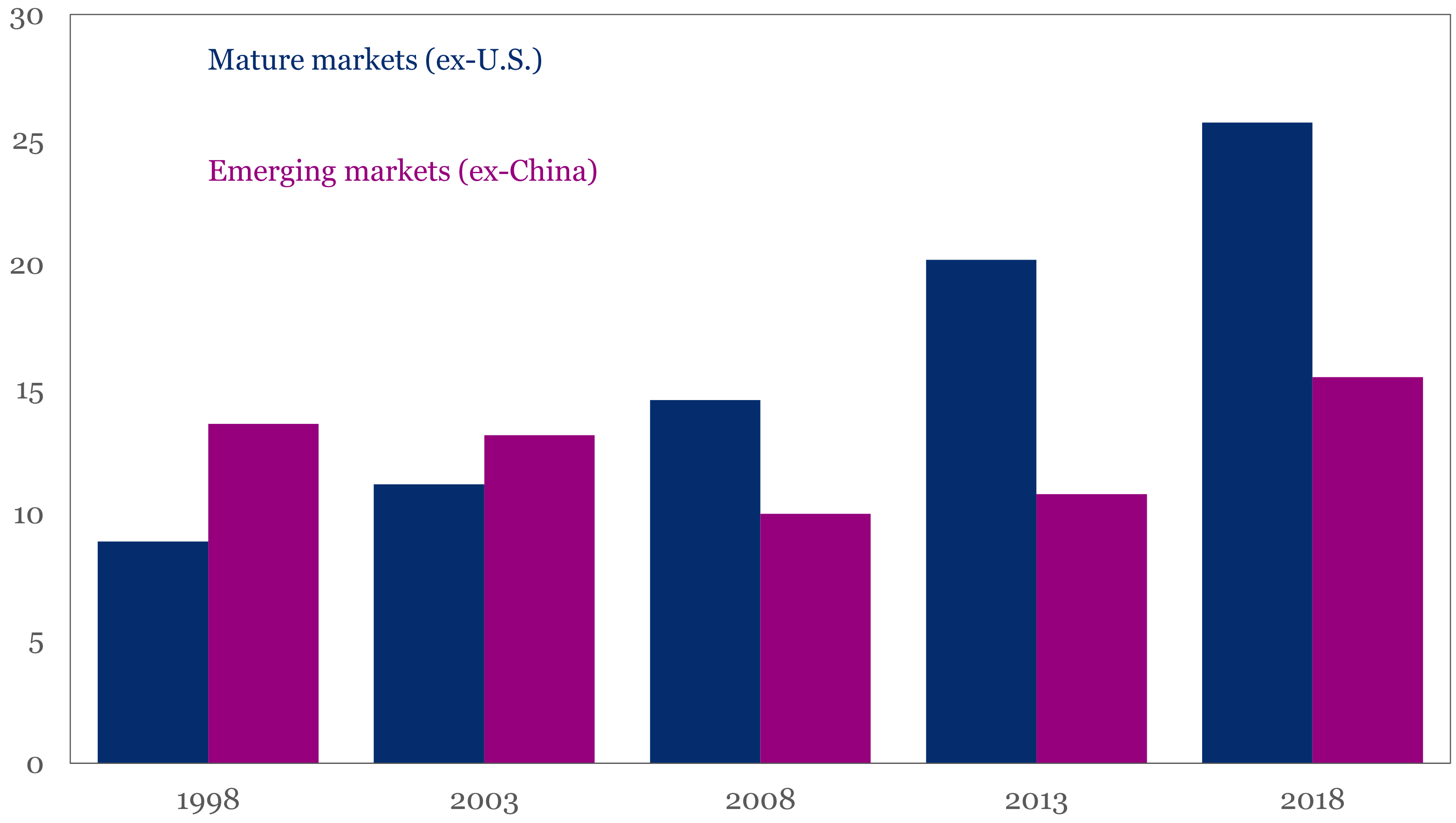
# EM concerns

- EM local currency transactions in general won’t be directly impacted. In fact, EM countries have been operating in a non-centralized regime for a while and some lessons can be learned from them about how to operate across jurisdictions.
- However, some factors across EM countries could increase the impact of the transition: highly dollarized economies, high levels of floating rate or FX-denominated debt (or even high foreign ownership of local debt).
- Monetary/FX intervention operations– particularly for EM pegged to an affected hard currency often occur via FX swaps or forwards—instead of spot markets.
- Also countries with relevant international reserves or cross-border outward investments (loans, real estate, etc) would be affected.

# USD-denominated debt is on the rise

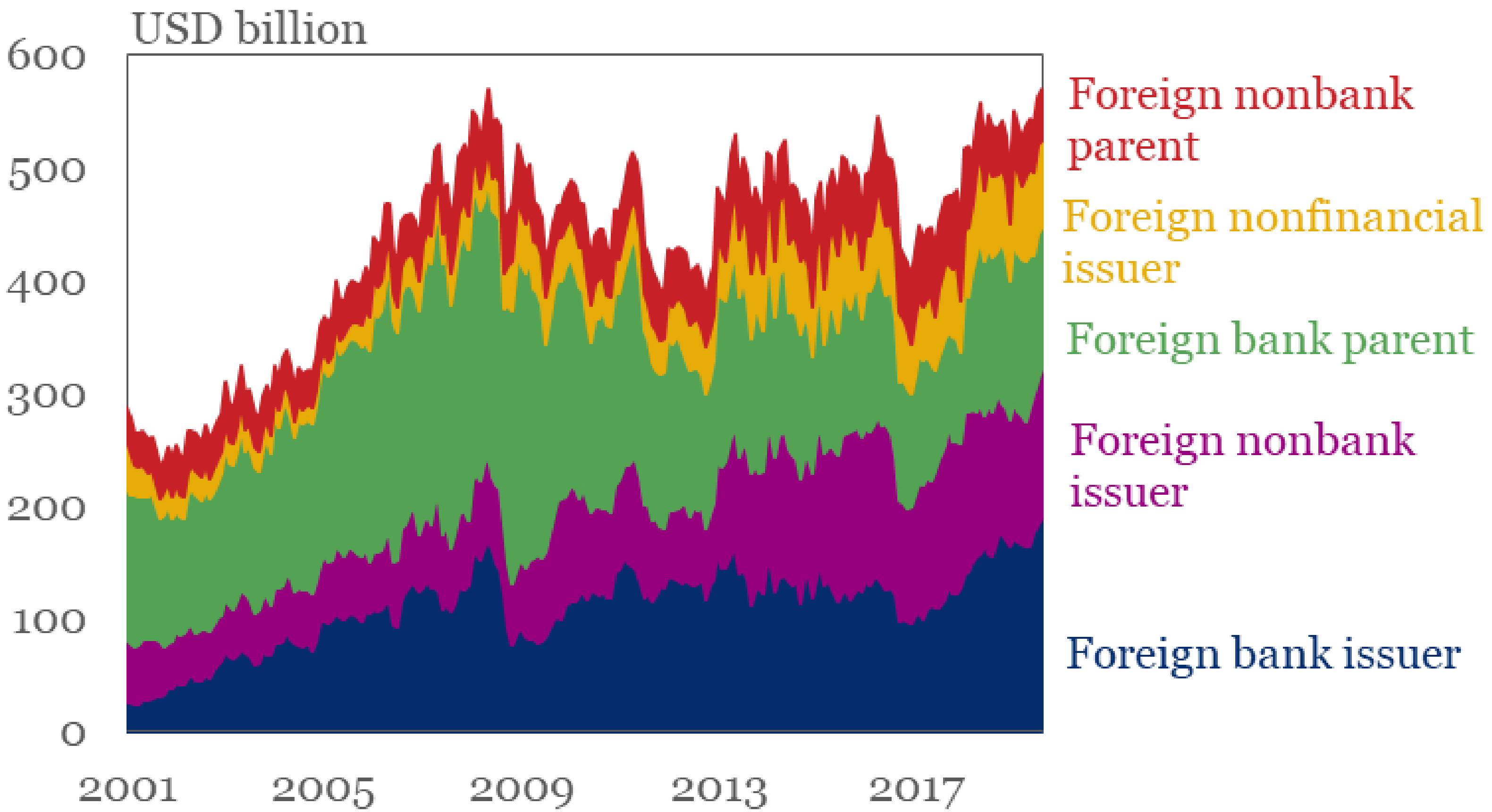
**Dollarization is a global phenomenon**

percent of GDP, USD-denominated debt of non-bank borrowers



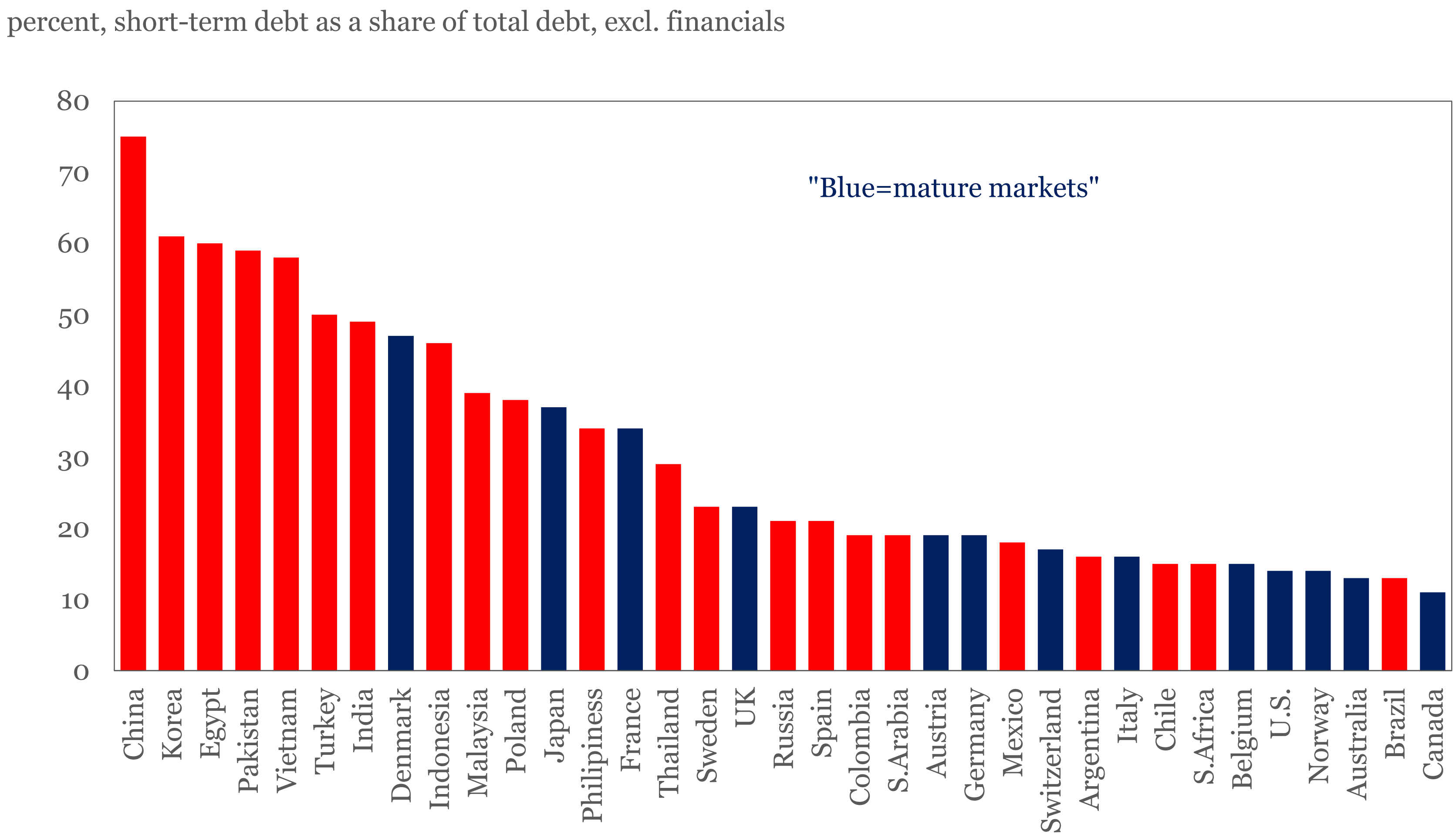
# Non-US corporates have been increasing their reliance on US short-term funding—especially banks.

Commercial papers in the U.S. issued by foreign institutions



# Reliance on short-term debt is high across emerging markets

## Emerging market firms face high short-term refinancing needs



# The buy-side perspective

- Although the tone among officials has been very positive about the transition, U.K.'s Financial Conduct Authority has expressed concerns about progress on the buy-side.
- Asset managers more specifically (important holders of EM securities) may face strict liquidity requirements and also encounter challenges from diminishing liquidity (and increased volatility) of LIBOR-linked instruments such as floating rate notes (FRNs), bank loans or derivatives.
- Money market funds that are largely benchmarked to LIBOR: moving to a new metric could lead to an unintended increase in tracking error, affect risk/return performance or even prompt selling.

# EM and global corporates

- Need greater support from the official sector in jurisdictions indirectly affected by the transition: hedging accounting, fallback language, timeline, etc

- Tax, accounting, and regulatory treatment of new benchmarks may greatly affect intercompany loans, transfer pricing or funding of sponsored pension plans, and ultimately impact earnings.

- Developing liquidity for underlying markets and derivatives linked to RFRs may also be crucial for EM corporates. After all, wide bid-ask spreads and stale asset prices render additional costs for companies' treasury operations.

- Companies need to proceed with individualized mapping and disclosure of risks associated with LIBOR cessation—governments should do the same.

# Relevant links

- ARRC (Alternative Reference Rates Committee)
  - A User's Guide to SOFR – April 2019
  - Fallback Contract Language
  - Interdealer Cross-Currency Swap Market Conventions – NY Fed

- The National Working Group on CHF Reference Rates

- Japan's Study Group on Risk-Free Reference Rates
  - Report on the Identification of a Japanese Yen Risk-Free Rate
  - Main Points of the Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks

- Working Group on Risk-Free Reference Rates for the Euro Area

- Working Group on Sterling Risk-Free Reference Rates – BoE and FCA
  - Discussion Paper: Conventions for referencing SONIA in new contracts

- International Swaps and Derivatives Association – ISDA
  - ISDA Publishes Two Consultations on Benchmark Fallbacks

- Principles for Financial Benchmarks - IOSCO