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IBOR-to-RFR transition: Impact of COVID-19

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It suffices to say that the COVID-19 episode, alongside its accompanying economic impacts, is the defining theme of this year. The management of this episode has greatly expended the administrative and governance bandwidth of not just the government and regulatory bodies, but also of private organizations. The banking sector is no exception. Aside from COVID-19, the IBOR transition is still ongoing. Given these competing demands on the banking sector, the question is whether the all-encompassing nature of the COVID-19 episode has, in whatever ways, hampered the transition from the IBORs to the risk-free rates (RFRs).

> *"Despite the array of challenges we're facing as a result of the coronavirus, transitioning away from Libor continues to be of paramount importance… The clock is still ticking, and it's critical that regulators and institutions continue to work together to ensure we are all ready…"*
>
> John Williams, NY Fed President, 13 Jul 2020

The essence of Williams' reminder could well have been echoed by the regulatory bodies which are overseeing the transition process. **However, the general sense is that the IBOR-to-RFR transition is probably not highest in the list of priorities in the early stages of the pandemic.** Anecdotally, banks and corporates could be seen diverting resources, both budgetary and manpower, to more pressing priorities such as managing liquidity, operational hazards and credit risk as they try to steer themselves through the pandemic. Emergency loans, issued by banks in the UK and partially backed by the UK government, were mostly LIBOR-linked, not Sonia-linked, despite the UK being the most advance in the transition. Thus, it is not a stretch to imagine that the progress already made and internal deadlines for the transition process may have been reversed or pushed back. Nevertheless, as the pandemic related issues ease, we expect IBOR transition to make its way back up the priority list.

On the regulators' front, there is at least some sympathy in view of the disruption. In some instances, intermediate deadlines have been relaxed, while keeping the final end-2021 deadline intact. This has allowed firms to focus on the pandemic in the short term without jeopardizing the overall transition. For example, in the UK, the Working Group on Sterling Risk-Free Reference Rates delayed the stoppage of all GBP LIBOR linked loans to Q1 2021. For now, these extensions likely suffice. However, if the course of the pandemic worsens, there will be a limit to how much intermediate deadlines can be extended without affecting the final deadline.

In reality, it is not in a national regulator's purview to extend the final deadline. **The final say falls on the UK Financial Services Authority (FCA) as the administrator of LIBOR rates to determine when to stop the publication of the LIBOR rates**. The FCA have stood firm with their initial goal of an end-2021 deadline, and this remains the hard deadline for other national regulators. The FCA is effectively in a Catch-22 situation. The pandemic is arguably sufficient reason to call for a deadline extension. Yet, a decision along those lines may be perceived as a sign of weakness, and risks the market betting that the transition might not happen altogether.

It may be useful to look at the region to see what is happening in Hong Kong. The Hong Kong Monetary Authority (HKMA) currently has no plans to discontinue the HIBOR, and will allow the HIBOR to run concurrently with the HONIA after 2021. Thus, the preparation for the switch away from HIBOR has been choppy at best.

A large number of contracts still rely on USD LIBOR as a reference rate. The focus is on the transition from USD LIBOR instead. The HKMA expects banks to be in the position to offer products referencing to the HONIA by 1 January 2021, and cease issuance of LIBOR-linked products by the end of 1H 2021. This transition has been seeing good progress despite the pandemic. A HKMA survey found that a majority of the banks have already established a bank-wide transition plan. More resources have also been allocated to address the implications of the transition, such as impact assessment, transition monitoring and contract re-negotiations.

Nevertheless, despite the good progress, the total amount of exposures to LIBOR maturing beyond 2021 has actually increased this year. This suggests that the inherent bias for LIBOR-linked products remain deep-seated, and the risks of the transition remain high.

Good progress seen in Singapore

In Singapore, the transition from the Swap Offer Rate (SOR) to the Singapore Overnight Rate Average (SORA) and the reform in the Singapore Interbank Offered Rate (SIBOR) has continued to see good progress from both the regulators and the banking sector.

A new consultation paper was issued on 29 July and a media release in 5 August underlined this progress. Among others, the key developments were:

1. The **key features** and the **calculation methodology** of the SORA, Compounded SORA rates for 1m, 3m and 6m tenors and a SORA Index were formalised.

2. MAS to issue **SORA-based floating rate notes** (FRNs) on a monthly basis starting August 2020.

3. A new "**SORA-centred approach**" was proposed in replacement of the previous multiple rate approach.

These developments addressed some of the main technical uncertainties and deepened the market for SORA-based products, making a significant stride towards greater acceptance of the new benchmark.

Formalised calculation methodology removes a key uncertainty

In our previous article on the IBOR transition in Singapore (see "SOR to SORA: Looking through the transition pain to long term positives", 25 March 2020), we highlighted calculation issues as one of the "transition pains". With the formalization of the key features and calculation methodology, this transition pain has been effectively removed.

In particular, the publication of the Compounded SORA at various tenors and the SORA Index standardized the compounding method, allowing end-users to better compare the new SORA benchmark with the old SOR and SIBOR benchmark, and also compare across various SORA-pegged products. From an end-user perspective, this clarity allows for more confidence in the new benchmarks.

MAS issued SORA FRNs deepen the SORA derivative market

Key local banks handled the first SORA derivatives and piloted the first SORA FRNs in 1Q 2020. Market making in SORA derivatives started in 2Q 2020. The issuance of SORA FRNs by the MAS is the natural next step in deepening and maturing this market segment. Singapore is one of the first countries to issue debt based on an alternative benchmark, and the effort can be used by other countries to forward their own initiatives in this area. More important than being world-firsts, this move effectively creates a pricing reference for SORA-based products and should spur hedging activities through the SORA derivatives market.

The MAS has concluded three auctions for 6m FRNs. The bids attracted at each of these auctions were quite consistent at approximately S$2.0b per auction. The first auction in August saw S$500m allotted, with the amount moving higher progressively to S$1.0b in the latest October auction. Perhaps in-line with the successively higher allocations, the cut-off spread has also inched higher. Using the cut-off rate and the 6M SGD swap OIS (vs. SORA), we obtain an all-in expected return higher than the 6M T-bill (albeit not a perfect comparable). We think this spread over the 6M T-bill reflects a premium for the unfamiliarity of the SORA-based MAS FRNs as a product. Nevertheless, this spread should gradually close when market participants become increasingly comfortable with the MAS FRNs.

SORA-centred approach simplifies the interest rate landscape

Previously, there was discussion for an "enhanced SIBOR" (now referred to as the "New Polled Benchmark") derived through a waterfall methodology. This was meant to be one of the benchmarks for the cash market among retail consumers and SMEs. Transitional testing found this "New Polled Benchmark" to be more volatile than SIBOR, a feature that may make it less

attractive to their intended audience, which valued relative stability. This may limit the value-add of this new benchmark.

Thus, it was proposed that the “New Polled Benchmark” be dropped in favour of the SORA. This may be seen as limiting the choices for end-users. However, can two loan products, pegged to different benchmarks and all else being equal, be sufficiently different to be considered alternative choices? It is perhaps more valuable for the end-users if the product differentiation is focused on other features, rather than the benchmark.

The OCBC Bank has launched SORA-pegged home loans into the consumer market to a very positive response, with more than $50m of loans approved in the first two weeks, and more than $700m approved to date. This suggests that there is no significant attachment to the SIBOR in the cash market, and that a SORA-pegged product can gain sufficient traction in the long term. We believe this further entrenches the notion that multiple benchmarks in the cash market are not required, and a simplification of benchmarks may compel product differentiation in ways more beneficial to the end-users.

The clock never stops ticking…

… so long as the UK FRA does not halt the process. At this juncture, there are no signs of the IBOR transition halting. Even if the FRA were to announce an extension (unlikely in our opinion), the eventuality of the transition to RFRs will remain unchanged. Thus, at least in Singapore’s context, the significant progress in this area in spite of the COVID-19 episode puts us on a good stead when the discontinuance of the LIBOR benchmarks arrives.

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