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THE SUNSETTING OF LIBOR: WINNERS, LOSERS, AND THE SECOND ORDER EFFECT

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The sunsetting of LIBOR has been in the making for a number of years. Preparations at all levels should be well in hand, making the switchover to the new alternative reference rates (ARRs) smooth, especially since the ICE Benchmark Administration (IBA) announced in November that it will continue publishing LIBOR fixings through June 2023.

Prepared for the Challenge?

What is not entirely clear is whether banks and other market participants are adequately prepared to overcome challenges that will likely arise from pricing and risk managing the new ARR-based products and derivatives. This is truly terra incognita, according to Mark D'Arcy, President and CEO of FINCAD, a derivatives analytics solution provider, and he shares his thoughts on this critical topic.

Some ARR's will be less problematic than others, but those with lower volumes of trading activity can pose challenges when transitioning, possibly in real time, from pricing models that were built around the $300 trillion LIBOR market. An enormous amount of money is at stake; given the size of the LIBOR market, even slight asset mis-pricings or misapplied hedging strategies could become very expensive for the institutions involved. This is the "second order effect" in the title: that is, while the smooth functioning of the market is of vital importance and seems to be assured, for financial institutions getting the analytics underpinning it right will be what separates the winners from the losers in a post-LIBOR world.

The Looming Spectre of Inflation and the Potential Impact on Derivatives

The potential and velocity of inflation is top of mind for many given the enormous influx of capital injected into the markets to parry the macroeconomic impact of the global coronavirus epidemic. 2021 interest rates remain largely unchanged, as we continue to operate in the same low rate period we have enjoyed for more than a decade. Should inflation materialize, it will bring with it a fresh experience, particularly for the newer market participants. Having adequate derivative analytics, including capabilities around credit valuation adjustments (CVA), funding valuation adjustments (FVA), and collateral optimization, will be invaluable.

It's a New Era

At the dawn of the internet a senior manager at Microsoft wrote a famous essay titled "Road Kill on the Information Highway". Many of his forecasts turned out to be wrong, but the overarching message was that a huge sector of the economy stood at a turning point and this, of course, proved to be correct. While I am not suggesting that the end of LIBOR marks the same sort of seismic shift as the coming of the internet, it does involve hundreds of trillions of assets and millions of customers, so it's scarcely a trivial event for those with risk on their books.

It’s easy to imagine some of the muscle memory gained working in an inflationary period has atrophied over the years. Add into the mix the sunsetting of LIBOR and it’s not hard to conclude there is elevated operational risk lurking inside many entities. Institutions will need analytics to navigate this transition, and to emerge among the winners in terms of maximizing profitability while actively managing the risk. Some are well prepared and others are just starting.

*Article courtesy of ValueWalk