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Revising Best Estimates for Libor Benchmark Reform

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The ongoing reform movement to phase out major interest rates, such as Libor and Euribor, is an undoubtedly justified reaction to a murky history for these benchmark rates. Attempted market manipulation, false reporting, and a recent pattern of decline in the liquidity of interbank unsecured funding markets have all tarnished Libor's reputation as a reliable benchmark.

However, for insurers, these apparent faults are a very distant reality from the imminent technical challenges presented by benchmark reform. So far, the focus of discussion throughout the financial industry has centered on impacts to assets like derivatives, bonds and loans that directly reference these scandalous benchmarks. Current efforts have included seeking out and identifying the contracts that are impacted, in addition to measures to robustify contract language for the event of permanent discontinuance or pre-cessation triggers in these asset classes. More recently, the conversation has progressed to address the upcoming financial reporting challenges. Proposals are being advanced for amending IFRS 9 and IAS 39 standards in order to provide relief against disruptions to hedge accounting relationships and balance sheet volatility arising from benchmark reform.

Unfortunately, this is still just the tip of the iceberg for insurers. Many are running sizeable ALM activities across multiple business lines, which are now showing signs of new risks from the increasing technical challenges of benchmark reform. At the forefront are the unknown impacts of benchmark reform on the risk-free term structures, which are provided by the EIOPA regulatory body in compliance with the Solvency II directive and delegated regulation. Within this regulation is a hard-coded reliance on the Libor benchmark. Up to now, EIOPA has been reluctant to make any announcements in response to these concerns due to the market-sensitive nature of any disclosures on the subject. This is however causing a heightened level of uncertainty on how to proceed for insurers who are currently seeking to move away from Libor and ready for its cessation.

In the face of this raft of complications and turmoil ahead, insurers are now considering a number of strategies for solving the Libor benchmark problem. Much of their work has centered around beginning to shift assets to alternative benchmarks like SONIA and €STR. On the asset side this is a serious effort, beginning with engagement in alternative rates markets and also understanding how current holdings will be impacted by Libor cessation. Updating technology, systems and infrastructure is necessary to build modern alternative rates curves, where important features from federal monetary policy and market-driven forces are required to extend OIS curves beyond discounting and take over for Libor multi-curve frameworks.

Given the widespread impacts, modern analytics libraries offer a potential way to neutralize some of the pain by centralizing the replacement of Libor across multi-asset portfolios. Furthermore, in providing fine-grained sensitivity analysis, the latest analytics technologies can quickly find opportunities to compress Libor exposures with alternative rate basis swaps. These are just a few of the reasons to consider updating asset management services with modern and future-proof analytics technologies.

Transitioning assets away from Libor is one thing, but there are even greater questions for actuaries and ALM and risk managers, as they wait to hear from EIOPA regarding risk-free term structures. The progress on the asset side only complicates things by introducing basis risk that cannot be hedged without additional guidance from regulators. The potential move to discount liabilities on risk-free rates and increase to the valuation of best estimate liability will have profound impacts on the capital requirements mandated by Solvency II regulation. According to recent reports, only a small fraction of insurers can currently calculate sensitivities to risk-free term structure on technical provisions, including rate term structure and key rate risk, Smith-Wilson parameters and the extrapolation methodology including LLP, transition period and UFR. Capital allocations could be significantly impacted by removing Libor from liability discounting, due to these secondary impacts, such as potentially reducing LLP owing to the different liquidity of alternative rates.

Part of the solution is to take a lesson from asset focused technologies. Using these technologies, the revision of estimates for capital requirements can be better understood and predicted with fine-grained sensitivity for the term structures used in technical provisions, including for BEL and RM and to inform scenarios for impact on MCR and SCR. This is yet another reason for insurers to update systems to modern analytics technologies, which provide these sensitivities, and model asset and liabilities in a single framework that can automatically replace Libor with alternative rates.