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ICRA Special Release

LIBOR 2021 Transition is a bigger deal than you might think...Is Sri Lanka ready?

Why it is such a big deal?

LIBOR is the most popular financial benchmark rate in the world with instruments linked to it grossing over US\$ 400 Tn globally. Post 2008 financial crisis, serious doubt has been cast over the credibility of LIBOR as a true reflection of the market. Consequently, in 2017 the Financial Conduct Authority (FCA) in the U.K. announced the benchmark will be phased out by 2021. This event will have a profound impact on the financial markets and has triggered many companies to start evaluating their options of transitioning out.

Central Bank of Sri Lanka (CBSL), Sri Lankan commercial banks and companies, including some of the biggest SOEs have substantial exposures to LIBOR linked instruments. Transition from LIBOR to Alternative Reference Rates (ARRs) will be much more complicated than a straightforward administrative change in the benchmark rate.

Therefore, CBSL and Sri Lankan companies must start getting ready for it. This is because there are major differences between LIBOR and ARRs, and in order to have a smooth transition, the impact of these intricacies must be understood deeply and reacted swiftly. In this publication we will look at how LIBOR transition affects loans, derivatives, and bonds and what measures can be taken by the institutions concerned and CBSL as the regulator to have a smooth transition.

Introduction

ARRs are robust, overnight interest rates which are derived from liquid underlying markets. In contrast, LIBOR is derived from interbank lending rates. Following the 2008 financial crisis, London interbank market has become thinner and is prone to manipulation. Due to this reason, FCA announced the discontinuation of LIBOR in 2021.





Five ARR's have been proposed to replace the respective LIBOR rates for each major currency (i.e. Sterling, US dollars, Japanese Yen, Swiss Franc, and Euro). Secured Overnight Funding Rate (SOFR) for US dollars and Sterling Overnight Index Average (SONIA) for Sterling have emerged as frontrunners.

In the context of Sri Lanka, SOFR will be the main ARR of interest due to the dominance of US\$ denominated instruments. Therefore, rest of this publication will mainly focus on SOFR.

Key differences

There are several key differences between LIBOR and SOFR.

- Unlike LIBOR, SOFR is a secured rate and is expected to be lower than LIBOR. Loans that fallback to SOFR will require a credit adjustment to make the rate more comparable to the current benchmark.
- SOFR does not have a term structure (i.e. overnight, 1 month, 3 months, 6 months etc.) such as LIBOR. Several methodologies have been proposed to develop term structures but the market is yet to see consensus from experts.
- LIBOR is a "Forward-looking rate" whereas SOFR is not. This means it is fixed and published at the beginning of each interest period for a number of different maturities allowing corporates to manage their cashflow by providing them with advance visibility as to their financing costs. On the other hand, SOFR, a "Look-back rate", is calculated based on daily historical data, therefore will have no advanced visibility to its users.
- Publication of SOFR only began in April 2018 and the analysts do not have a good understanding of how it will evolve in future. Historical data shows, SOFR is more volatile than LIBOR. The spreads show variations across economic cycle.

Implications for loan products

Due to the aforementioned differences and some technicalities, transitioning from LIBOR to an ARR is going to be quite challenging.

Lack of advance visibility of SOFR (or any other ARR for that matter) is especially problematic for certain cash products such as loans. As a result, companies may need to hold additional cash balances to buffer any interest rate movement during the interest period, which will have an impact on the current cash management processes.

Certain cash products may be linked with swaps to hedge the currency or interest rate exposure under them. As various products are at different stages in the transition away from LIBOR and are adopting divergent approaches, the concern is that this could lead to basis risk. In addition, loans and derivatives may incorporate different fallback trigger events which may also lead to basis risk.

Implications for derivatives

ARRs are more compatible with derivatives than cash products. Though the use of SOFR for consumer products is still doubtful, for derivatives SOFR will likely to be the replacement. Complicated products such as cross-currency swaps could be exposed to multiple ARR's due to their cross-border nature. LIBOR embeds both credit and term risk therefore the applicable margin will typically be the same across different currencies under the same instrument whereas it's not the case with ARR's. This may pose a basis risk.

In addition, bonds are generally hedged against currency or interest rate risk using derivative arrangements. The trigger events for bonds and derivatives can be different and it would lead to basis risk.

Implications for CBSL

Sri Lanka has a considerable amount of floating rate (17% of the total debt in 2017) and FX denominated debt (49% of the total debt in 2017).



This may compound the impact of the LIBOR transition on the economy.

CBSL issues US\$ denominated Sri Lanka Development Bonds (SLDBs) from time to time to raise funds. As of 31st July 2019, there are over US\$ 1.3bn worth LIBOR linked floating rate SLDBs maturing after 2021. The main implication for SLDBs comes from the fall back language of the bond offer document. The fallback terms in the SLDBs are designed to handle cases where LIBOR is temporarily unavailable and are not geared to address the phase out of LIBOR in a sustainable manner. In the current form, eventually, the floating rate will fall back to a fixed rate and this may not be commercially acceptable to CBSL or investors. In addition, this may also initiate some litigation against CBSL by bondholders.

CBSL may issue SLDBs entering into associated swaps. As pointed out earlier fallback terms of the bonds and swaps may have different trigger events or operate different methodologies creating basis risk for CBSL. From the bond investors' perspective, they may also enter into swaps and the basis risk may affect their expected return.

CBSL also issues Treasury Bonds on a regular basis and there is a sizable foreign participation in the bond market. Foreign ownership of Treasury Bonds may be affected due to the LIBOR transition as bond holders swap their exposure back to the rupees. If there are no markets developed for SOFR for hedging of the local currency this may pose an impediment.

What needs to be done

Working groups in both the US (Alternative Reference Rates Committee) and the UK (The Working Group on Sterling Risk-Free Reference Rates) are encouraging companies and other entities to transition from LIBOR to the greatest extent possible from now itself. Therefore, the work must begin now.

First of all, a wider discussion on the transition of LIBOR should be initiated. In addition, CBSL should set up a working group of stakeholders to prepare a transition framework and coordinate the effort of

transition. CBSL can also ask companies with substantial exposure to LIBOR to provide details of their preparations to manage risks inherent in the transition from LIBOR to alternative interest rate benchmarks.

Institutions must conduct an impact assessment and should consider exposures across financial products, contracts, systems, and models. Companies can draw up their own implementation roadmap outlining various aspects of impacted businesses and functions. Furthermore, they must consider the optimal timing for amending any existing products in light of overall market conditions, and borrower specific circumstances.

Key consideration when it comes to LIBOR transition is the fallback language of the cash and derivative products. Increasing flexibility to agree amendments in the future, including by lowering the lender consent threshold to agree amendments to the relevant provisions is one solution to consider. Another option is to have SOFR (or other relevant ARR) hardwired into documentation now, thus avoiding the need for amendments in the future.

The transition from LIBOR to SOFR (or any other ARR) may necessitate upgrades on existing operational systems. These changes may take months to implement and cost could be significant. In addition, companies may have to introduce modifications to treasury management systems to accommodate such changes.

It is important to manage investor perception of SLDB issues referencing LIBOR and maturing beyond 2021 by addressing the LIBOR transition from now onwards. The most prudent way to avoid this is to have SOFR as the reference rate for floating rate SLDBs that will be issued in future. But in order to make this transition CBSL systems should carry out the necessary system upgrades, develop robust fallback language and amend the consent threshold level.

Another avenue the CBSL can explore is the possibility of converting legacy bonds referencing LIBOR to SOFR. However, the switching is particularly complex for bonds as unlike in the case of derivatives, amending the terms of a bond





contract requires bondholder consent. In addition to equate LIBOR to SOFR, the CBSL would have to incorporate an adjustment spread. CBSL should initiate the consent solicitation from LIBOR to SOFR from now onwards.

From the credit rating standpoint, managing the risks associated with LIBOR transition may be seen as a positive action to reduce credit risk.

Conclusion

Discontinuation of LIBOR should not be considered a remote event; CBSL, banks, and firms who are exposed should treat it as something that will happen. CBSL, banks, and companies must assess the impact and the transition should start immediately and in coordinated fashion.

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