Tackling the Complexities of IBOR Transition

Time is running out for treasurers to complete their interbank offered rate transition projects with the deadline of December 31 2021 rapidly approaching. A recent TMI webinar with Salmon Software brought together three experts to discuss the complexities ahead, examine how treasurers can ensure they are prepared for them, and review the role technology can play in supporting this transition.

By **Ben Poole**, Columnist

A significant number of corporate treasurers have yet to start their preparations for the changes that will be triggered by the interbank offered rate (IBOR) transition deadline at the end of the year.

That was the finding of a poll, which aimed to gauge how corporates have progressed towards the transition, conducted among treasurers during a recent TMI webinar. Given the options of 'not started,' 'partially started and confident on deadlines,' 'started but having issues,' and 'fully completed,' the majority of attendees were split into two camps: those that have started and are confident of deadlines (41%) and those that have not yet even begun (38%).

"It is rather surprising to see that quite a few of the audience haven't started yet," commented Svenja Schumacher, Assistant Director, Treasury Advisory, Deloitte. "The very first task on everyone's 'to-do' lists should be the identification of exposures, which can take quite some time. Some exposures are easier to identify, for example, if you think of debt contracts or derivative contracts, most of those are stored in a TMS [treasury management system]. But you could also have less obvious exposures, such as lease contracts, intercompany contracts, things that could be hidden outside of treasury within the organisation."

As well as identifying all IBOR exposures that exist within their organisation, treasurers must also ensure they have the right technology in place to handle the new requirements.

"Treasurers need to check if the system that they're using is ready to accommodate

the new way of capturing the information from their transactions and deals," said Tassos Dimopoulos, Director of Project Management, Salmon Software. "They also need to start testing well in advance of the deadline so they are comfortable that all the elements, from accounting to tax, settlement calculations, and accruals are in place."

The webinar also featured a direct treasury perspective from Shaun Kennedy, Group Treasurer, at Associated British Ports (ABP), who explained that ABP had begun its IBOR transition project back in 2018 and is aiming to be ready before the deadline.

"I'm fairly confident that we've given ourselves the best shot to get everything completed by the deadline, but there's certainly plenty to do," explained Kennedy. "What has surprised me, going through this, is just how difficult it can be to move into a compounding interest in arrears process. We have achieved a lot in terms of understanding our exposures, looking at our documentation, understanding the formulas and the options around risk-free rates [RFRs], and making sure that we have systems in place that are going to do what we need them to do. I spend quite a bit of time with our treasury accounting colleagues to make sure they are aware of what's going on and I also liaise regularly with our banks and other financial counterparties. I believe we're as ready as we can be, although it still feels as if we still have plenty to do in just under six months."

The scale of change

Perhaps the most important point to consider about the IBOR transition is that it is not as simple as swapping one rate for another. The new risk-free rates (RFRs) differ dramatically from IBOR rates, where in any IBOR transaction treasurers are dealing with a single rate that is known from the beginning, regardless of frequency, giving time to calculate settlement and to calculate accruals. This is not the case with the RFRs.

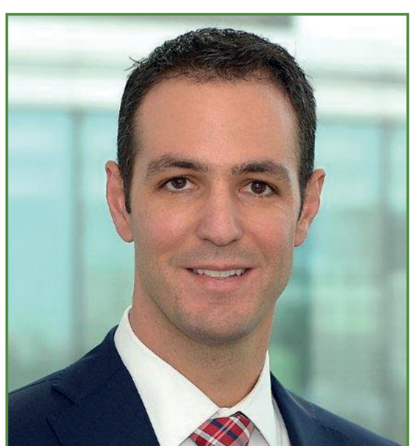
Dimopoulos noted: "The calculation with the new rates is much more complex, because we're talking about a daily compounding. Then, if you think of a deal that has a monthly fixing instead of a single rate, you're talking about something in the region of 20 to 25 different daily rates that need to be used in the calculations. If we're talking about a quarterly deal, it must be somewhere in the area of 60 to 70 different rates – it grows as we go. On top of that, that is something that happens in arrears, so if we introduce a lag of five days, we have five business days to calculate our settlement and settle it with the bank. That is a huge change, and one that is not very easy to manage if you try to do it manually to any degree."

The point about manual processes is critical. With rate calculations increasing so dramatically, the time spent on this by treasurers who are using spreadsheets would also increase exponentially, as would the potential for costly errors.

"If a treasury team is continuously using Excel, they will need to employ more people just to monitor sales, and then the operational risk increases exponentially," warns Dimopoulos. "Besides that, the Bank of England has suggested rounding on 16 decimal places or more for SONIA [sterling overnight indexing average] calculations, and Excel is designed to handle only up to 15 digits per number, everything else is rounded, so you don't have 100% accuracy. With the size of transactions that corporate treasurers deal with, this is a serious problem. You need to have the right treasury technology in place, alongside updated processes, to have confidence in calculating these new rates."

Schumacher agreed with Dimopoulos that it is vital for treasurers to be fully engaged with the intricacies of the new calculation methodologies. She added: "Treasurers need an understanding of the ins and outs of cumulative and non-cumulative compounding, examining look-backs with and without observation shifts, and checking what the standard is in their various contracts - the debt market and derivative market may not have the same standard and you may introduce a mismatch if you just follow through what has been suggested by the banks. It's important to update your processes, for example with LIBOR fixing in advance you previously may have had a couple of months to get ready to make the payment. Now, with risk-free rates compounding in arrears, it's just a matter of a few days to calculate your interest and get ready for the payment."

From the treasury perspective, Kennedy explained the challenges that he and his team have addressed as part of their IBOR transition project: "Treasury has been hugely involved in this process because we understood the potential impact on our treasury arrangements across all products. From a TMS perspective, we knew where our exposures were, what we didn't have in the system was what the fallbacks were, and what they were likely to do in the event of LIBOR cessation. We had a good understanding



TASSOS DIMOPOULOS

Director of Project Management, Salmon Software

SHAUN KENNEDY

Group Treasurer, at Associated British Ports (ABP)

that the fallbacks in all our products were not sufficient, they did vary by product, and this was something we needed to look into."

Review the technology

Having the right treasury solution to support IBOR processing and the transition to the new RFRs is essential for treasurers to have the visibility they need into their exposures. In a snap poll of the webinar viewers, around 20% said that they had completed a full review of their treasury technology and were happy with the outcome, while a majority reported that this was currently under review at their organisation. That left around 25% of participants who either did not know whether their technology supported IBOR processing, or knew for certain that it did not and that they required a solution.

Once the requirements were understood at Salmon, the technology firm began planning the process of transitioning and capturing the daily compounding. It soon became clear that it would be difficult, if not impossible, to try to shoehorn a solution into the company's existing functionality due to the differences between the new RFRs and IBOR.

"We had to take a step back and redesign quite a few areas of the system," explained Dimopoulos. "We had to introduce new modules to capture the loans and the swaps of our clients, we had to redesign our accruals modular accounting output to be able to capture this new reality. We also understood that some corporates wouldn't be looking for a full-blown treasury solution. Some will just be looking to get away from Excel calculations, particularly smaller corporates, so we have also started developing a web-based application that will purely be focused on these new elements of calculating the daily compounding and capturing the loans, for example."

SVENJA SCHUMACHER

Assistant Director, Treasury Advisory, Deloitte

Companies already using a TMS would be wise to review the technology in place to check that it has the capabilities to help and not hinder life in the post-IBOR world. "Having a good treasury management system is crucial," commented Kennedy. "This move to having daily risk-free rates places even greater importance on that, and we've seen, in our treasury contracts, that we've already moved to SONIA. We started by building some models in Excel just to get our heads around the change and having conversations with the team at Salmon about what we were moving towards, but the reality is when you go into the detail of it – for us we're looking at 150 different contracts. It's just not feasible, particularly when they all happen to settle on Boxing Day every year. This creates a really painful few days just before Christmas. It just wouldn't be possible without a system in place."

Salmon also had to ensure that the solution it developed was flexible enough to react to, and include functionality for, any additional requirements that could arise over the coming months and years.

"We had to ensure that any additional element of calculation could be easily captured – we may be talking about a lag or a lag with a shift," explained Dimopoulos. "But there are other proposed approaches where we have to make sure that if a client has even a single loan that is using that approach - anything from indexing to averaging, for example – then we have to make sure that it can be easily introduced, if it is not already in the system."

Kennedy agreed: "The conventions are evolving all the time. There are different options out there, in different currencies, even in the past 12 to 18 months. Initially we weren't looking at floors, for example, because we'd been looking at swap transition. But when we started to look at loans, floors became an issue in terms of how they would be done in the SONIA RFR world. You do need to have flexibility in the system to manage this."

The devil is in the detail

The webinar session also highlighted how quickly the IBOR transition deadline will be with us, the complexities that treasurers need to understand about the new RFRs, and how technology can support treasurers in this new world.

Kennedy observed: "It seems like a small change – we're just moving from knowing the interest at the beginning to knowing it at the end, and just compounding it – in principle this should be straightforward, but it's really not. That's probably the main thing that I've learnt in the past few years, just how complex really small changes can be. But they are essential, and they're ones that we do need to make. I also think they are positive for corporates, in the grand scheme of things."

The takeaways from all three panelists stressed the importance of treasurers addressing this transition as soon as possible. Schumacher said: "My key learning about the IBOR transition is that the devil is in the detail. As soon as you scratch the surface, you come across additional challenges. My best piece of advice would be to get engaged with the education around the topic, get your hands dirty and dive into the details to make sure you're not worse off in the end."

Kennedy, having been on the IBOR transition journey himself, urged treasurers to play a key role in this change within their organisations. "Take the lead on your transition, decide what you want from risk-free rates, and then tell your banks and your financial counterparties that's what you're going to do. That means spending the time to look into it and think what's best for you. There's not necessarily a one-size-fits-all approach, but there are recommendations."

Dimopoulos concluded: "While we're talking about a deadline of December 31 2021, that's not the end of the process. That is just the beginning of the change. I would relate it more to a marathon than to a sprint. Of course, we have to sprint to December 31 to make sure there is something in place. But from that point on, in the coming months and years, there will be many more changes introduced – and we all need to be ready for them."