Life after LIBOR: Are you ready?
The end of the London Interbank Offered Rate (LIBOR) as a benchmark in the not-so-distant future will have a significant impact — directly or indirectly, depending on country product conventions — on some mortgage lenders and their customers. LIBOR plays an important role in financial markets, acting as a reference rate for cash products and derivative contracts held by a wide array of market participants. It is extensively embedded throughout a range of processes, systems and models across industries and market segments.

However, there’s no need for alarm. Forward-thinking lenders still have time to take action and prepare for a smooth transition.

LIBOR, a measure of the average rate at which banks are willing to borrow wholesale unsecured funds, is no longer considered a reliable global interest benchmark. After more than 40 years of operation, LIBOR will cease to exist as a benchmark at the end of 2021. The consequences will be far reaching: LIBOR is currently used to price about USD 370 trillion of financial contracts daily. It also serves as a critical benchmark rate-of-performance measurement for investment securities and as a proxy rate for wholesale funding. Estimates suggest that there are about 200,000 LIBOR-linked residential and buy-to-let mortgages in the UK market, and each of these will need to be redeemed or transitioned to an Alternative Reference Rate (ARR), such as the Bank of England’s Sterling Overnight Index Average (SONIA).

DXC Technology has been working with specialist advisory firm Stratagem Partners to build and pilot methodologies, tools and models to assist banks in addressing their LIBOR transition requirements. Based on this work, our overriding observation is that the impacts of a transition are significantly more extensive and complex than many clients expect.

LIBOR is deeply entrenched within the operating models of many mortgage lenders. Changing to other, less mature benchmarks creates market and operational risks and raises concerns for market stability. Transitioning to SONIA or other benchmarks has an impact on how lenders will price mortgages, appraise suitability for customers and manage risk. Other complications further compound transition risk: trigger events; third-party dependencies; and economic, financial, legal and regulatory considerations.

Typically, existing contractual fallback provisions have not considered the permanent disappearance of LIBOR. As a result, problems are likely to surface when it goes away: unforeseen procedural gaps, economic transfer issues dealing with LIBOR’s adjustment spreads, and conduct and litigation risks.

Many lenders can ill afford to waste time and must urgently start remediation activities if they are to beat the 2021 deadline. Implementing potentially large-scale product, transaction, technology and process remediation, however, presents considerable execution risk.
Are you ready to manage a complex and potentially costly transition?

The lower volume of LIBOR mortgage products in the UK market compared to some other regions may create a level of complacency among certain lenders. However, low volumes don’t necessarily translate into less complexity and risk. Research suggests that while some Tier 1 firms are well under way with their risk assessments, many smaller global financial services firms have made little progress in preparing for the transition. In fact, some mortgage lenders are still launching and issuing LIBOR mortgages.

Critical questions that mortgage lenders need to consider in managing their transition to SONIA or other benchmarks include the following:

• Have you identified and assessed the exposure of your current and future mortgage portfolio to LIBOR transition? Do you fully understand the risks?

• How large and variable will your “basis risk” be at inception, during the transition, and at the end of 2021?

• How will your hedging strategies change in terms of asset liability management?

• How much of your mortgage portfolio will be refinanced or mature prior to the end of 2021?

  - Do you expect any existing mortgage products to survive beyond the current planned LIBOR end date?
  - Do you plan to issue SONIA-based mortgages prior to LIBOR transition?
  - Have you evaluated the benefit of SONIA versus base-rate mortgage products?

• Are you part of any loan syndicates? If so, will you have difficulty in agreeing to the new wording required to adapt existing loan agreements to the new benchmark?

• Have you assessed the scale of potential legal, contractual and regulatory exposure to LIBOR transition?

• Have you prepared adequate contract fallback language for new LIBOR loans being issued?

  - Is there sufficient flexibility in the language to accommodate developments within SONIA?
  - Are existing fallback clauses sufficient to cope with LIBOR’s ceasing to exist indefinitely?

• Have you identified changes to your operating model necessitated by LIBOR transition, including systems modifications and process and procedural changes?

  - Have you identified business opportunities to streamline operations and products?
  - Do you have a robust plan to deliver the required changes in time?

• Are there any treasury or capital markets concerns for pricing, liquidity, market fragmentation and the potential divergence between cash and derivatives markets?

While some Tier 1 firms are well under way with their risk assessments, many smaller global financial services firms have made little progress in preparing for the transition.
• Do your channels (including brokers) understand why LIBOR is being replaced and the commercial, pricing and conduct-of-business implications for borrowers as well as for you as a mortgage lender?
  - Do borrowers understand that the SONIA benchmark poses a risk of making it harder for them to know how much interest they owe because the rate is backward-looking?
  - Are you aware of concerns that the proliferation of alternative SONIA term rates offered by various lenders could spark allegations of mis-selling?

For small and midsize mortgage lenders with LIBOR products, there is probably merit in creating cross-industry co-operation. These lenders can share learning and experiences and potentially collaborate to develop joint solutions involving common technologies, processes or contracts.

**How the right tools remediate risk**

One of the key tasks in remediating risk is properly amending large numbers of mortgage contracts to fit the new terms. Re-papering existing mortgage contracts presents significant logistical challenges. In fact, simply locating relevant contracts and determining any provisions to be amended can be difficult. Furthermore, in most circumstances, the lack of contract standardisation across mortgage products involving LIBOR precludes a protocol-driven solution such as those being considered in other capital markets asset classes. Consequently, the contractual renegotiation process becomes significantly more cumbersome and demands a well-considered customer outreach program as well as the latest technology.

A strong re-papering solution supports a range of functions:

• Produces an inventory of all LIBOR-linked transactions and contracts

• Assists in developing a client strategy and playbook following analysis of the impacts of converting LIBOR mortgage contracts to SONIA, including customer, legal and regulatory issues

• Implements industry-leading technology leveraging artificial intelligence (AI) — trained specifically for the LIBOR transition challenge — to extract relevant data and feed a data model that can be used to reconcile exposures recorded in other products and risk systems to create a credible “gold source”

• Establishes a “gold source” reporting dashboard that gives accountable executives the confidence to assign priorities to those workloads deemed to have the greatest risk exposure and to accurately report these to regulators and management

• Employs robotics to re-paper simple contractual clauses following the agreed-upon playbook and to identify situations that require legal input as exceptions

• Deploys continuous machine learning to reduce the need for costly legal input, accelerate the burn-down rate and trim processing costs — optimising the playbook and level of robotic completion by feeding back the knowledge acquired from client outreach efforts and successful agreements for replacement products and contracts

• Uses case-management tools to provide end-to-end status of workloads feeding management-reporting throughout the remediation program
In conjunction with a multi-disciplinary team of banking experts from Stratagem Partners and our business partner network, DXC has developed a set of tools to ensure rigour, augment human effort and reduce the significant cost and timescale required to transition from LIBOR to SONIA in the UK. These tools include LIBOR contract re-papering support, data extraction, and analytics that consolidate legal and core product system data to help prioritise remediation of risk exposure.

Preparing for life after LIBOR is complex, but it doesn’t have to be difficult or daunting. Organisations that start now to identify and remediate the necessary changes will avoid unpleasant surprises and be well equipped to serve their customers in 2022 and beyond.

Authors

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Ray Nulty is chief executive officer at Stratagem Partners, a specialist international financial services advisory firm focusing on strategy, risk and public policy. He previously held global responsibility for the financial services practices at a number of major consulting firms. Ray has chaired reviews of key industry developments and policy proposals on behalf of governments, regulators and industry associations.

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