Global Research & Analytics

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CSAR is a robust replacement for Libor, says CRISIL

Underlines how banks can execute transition programmes

Analysis by CRISIL GR&A shows that the Adjusted Risk Free Rate (RFR) calculated using the Compounded Setting in Arrears Rate (CSAR) is statistically the most robust fallback alternative to the London Interbank Offered Rate (Libor), because it is the closest to reflecting Libor market conditions (*please refer to charts in appendix*).

(You can read CRISIL GR&A's whitepaper at https://www.crisil.com/en/home/our-analysis/reports/2019/02/libor-transition.html)

Kshitij Bhatia, Director, CRISIL GR&A, said: "Although CSAR will significantly change interest-rate coupon payments and related operations, and may not completely retain the present value of transactions due to the timing of fixings, this method has several advantages over alternatives for Libor-based derivative trades."

In July 2017, the UK's Financial Conduct Authority (FCA) announced it will not be asking banks to submit Libor quotes from 2021, although banks may continue publishing their alternative reference rates (ARRs) using other methods.

A year later the FCA, along with other regulators globally, emphasised the need for banks to prepare for the transition. This has led to much discussion in the global banking industry and led to the formation of working groups across geographical jurisdictions, to identify ARRs based on actual transactions to replace Libor.

Such groups have focussed largely on ARRs to help market participants prepare for a smooth transition. These are based on the overnight cost of borrowing secured or unsecured debt, and are typically based on some risk-free rate.

CRISIL GR&A expects the ARR-based financial instruments to pick up trading volume in 2019 and beyond, along with Central Counterparties (CCPs), to come up with term rates.

V Srinivasan, President, CRISIL GR&A, said: "There is an urgent need for the finance industry to finalise a fallback for cash products similar to derivatives products. Most cash products are hedged using derivatives transactions. The CSAR setting may be a good alternative for maintaining hedge effectiveness."

CRISIL GR&A believes banks must identify and evaluate front-to-back processes, ranging from trade capture to risk management, when transitioning to ARRs for existing and new trades with Libor dependencies. This will involve detailed analysis to showcase Libor exposure, at both currency-level and maturity-level, across bank desks.

Banks will also need to increase efforts required for bilateral and multilateral trade compression. This will make the transition programme operationally efficient and reduce the risks in transition to ARRs.

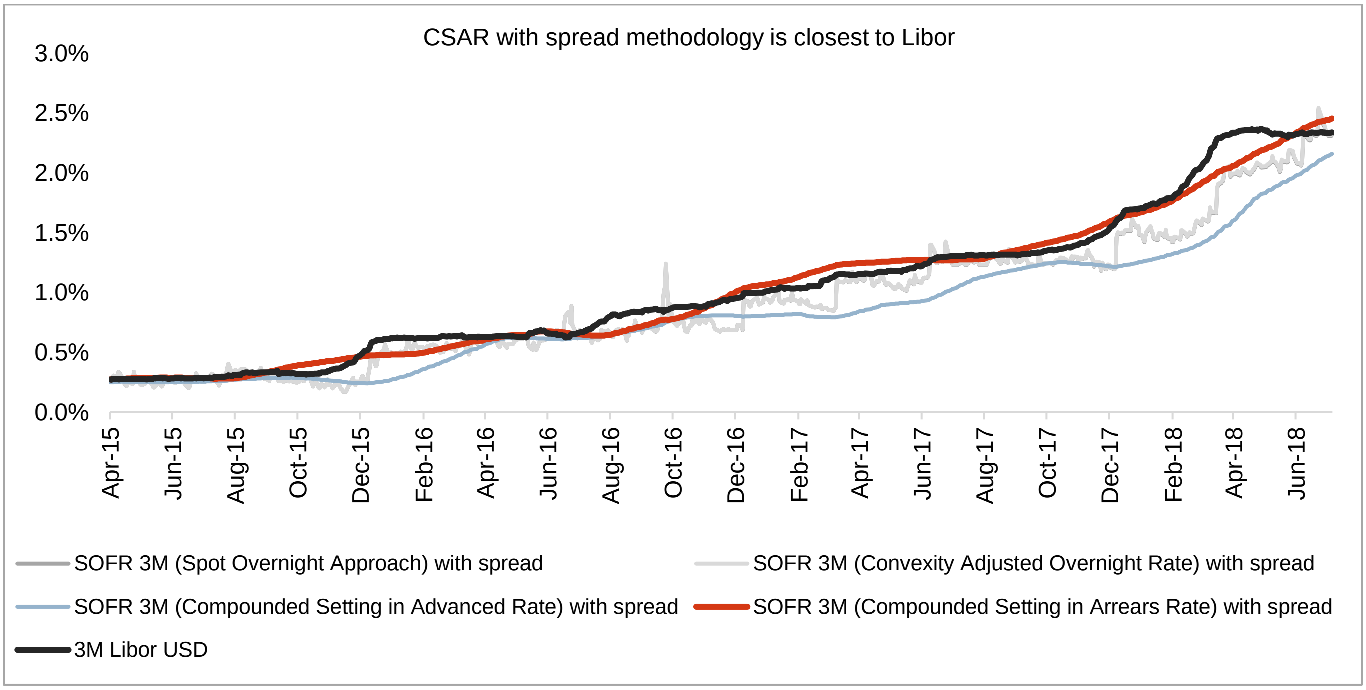
While banks are making efforts under the European Union's Markets in Financial Instruments Directive II (MIFID II), speeding up the process can reduce the challenges posed by the transition. Banks can then share their final transition plans with consumers and regulators to build confidence in their preparedness.

Libor has been the primary global benchmark for short-term interest rates for more than 30 years. It covers an estimated $350 trillion contracts for loans, swaps and derivatives, and is calculated using estimated cost of borrowing quotes from panel banks.

Libor is calculated based on the judgment of banks rather than actual transactions. That, along with evidence of misuse of the Libor system uncovered in 2012, has led to the banking industry moving to a more structural approach to fix benchmark rates based on actual transactions.

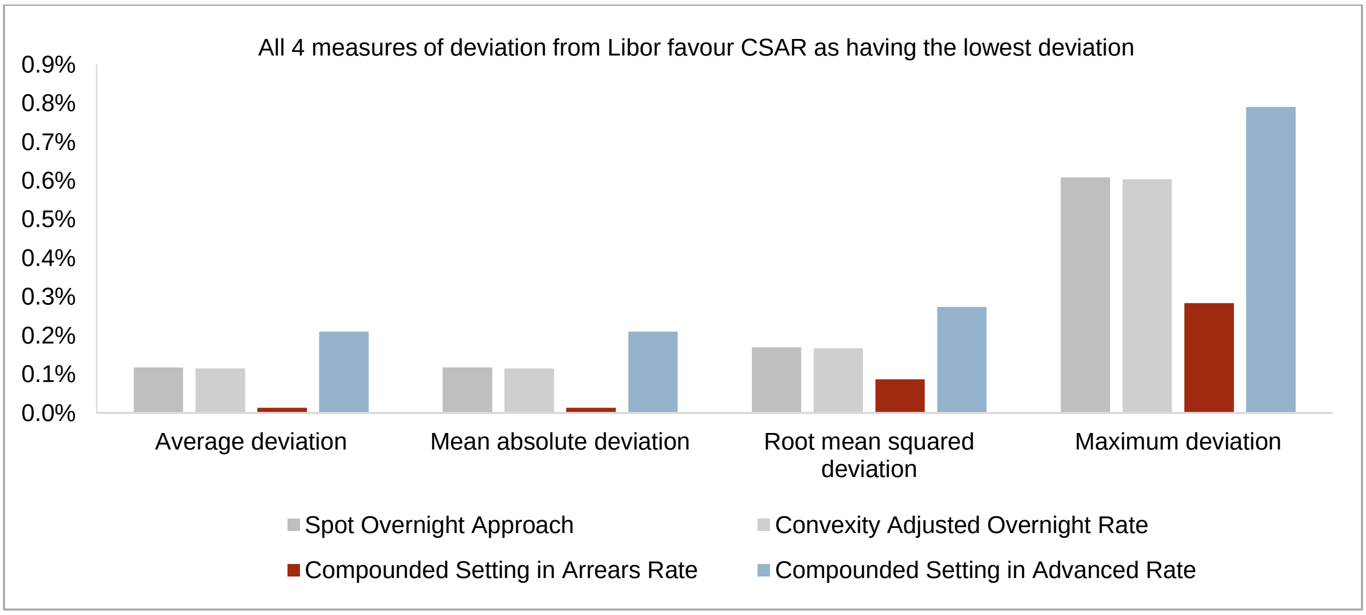
Appendix

Back-testing analysis of ISDA's suggested fallback methodologies



*The Spot Overnight Approach coincides closely with Convexity Adjusted Approach for this period.

SOFR 3M: Measures of deviation from Libor 3M USD across Adjusted RFR methodologies



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