

Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

October 16, 2020

LIBOR Transition for Derivatives

Please see this week's [Rate Sheet](#) and [Yield Curve Opportunities](#).

Economic data has taken a downturn since late summer. Last week, the number of new applications for unemployment benefits increased to 898,000, the highest unadjusted figure since July, as reported by the Labor Department. Even a decline in the number of continuing unemployment claims, which fell 1.17 million to 10 million this past week, is potentially an ominous sign of the state of affairs. When a person has reached the limit of time they are eligible for state unemployment, they may file for the federal extended benefits program, which will expire at the end of the year, without additional stimulus. The number of people on that program has seen sharp increases lately, rising to 2.78 million, from just under 2 million, at the end of September. The idea that people are remaining out of the workforce for extended periods of time helps explain why financial markets seem so attuned to fluctuations in sentiment around the prospects of new stimulus in Washington. Lawmakers are no closer to reaching a deal on that front. Ultimately, our theme of hedging the balance sheet to a neutral position in order to prepare for interest rates to go in any direction remains the same.

This week, we provide an update on two developments in the world of derivatives: one from the accounting side, and one from the International Swaps and Derivatives Association, both relating to the upcoming LIBOR transition. The LIBOR transition warrants a larger conversation, based on its projected impact on a variety of asset types, liabilities, and off-balance sheet items. These updates address some specific areas with recent developments.

Hedge Accounting - ASC 848

The FASB released ASC 848 Reference Rate Reform in March 2020 to address potential concerns on the impact of the upcoming LIBOR transition on hedge accounting. Although LIBOR fallback is expected at year-end 2021, guidance is applicable immediately to help users today explore potential alternative contracts and rates. It allows banks to be proactive in dealing with LIBOR cessation and identify a new hedged exposure. While doing so, index, deposit balances, reset/payment dates, and interest rate floors should all be considered. The bank can then modify the hedge to match the new (non-LIBOR) exposure, adjusting the fixed-rate or adding a floating rate spread to keep transaction NPV-neutral. Finally, the bank can amend their hedging memo to reflect the new exposure, and the hedge relationship continues without de-designation.

There is a positive balance sheet strategy development that comes from this guidance. By allowing banks to consider a change to a non-LIBOR hedged item, it essentially provides added flexibility to banks that have implemented strategies using wholesale funding paired with swaps, a strategy that many banks smartly continue to explore. The guidance allows those banks to consider replacing the existing funding with deposits or other sources of cheaper wholesale borrowings without any impact to hedge accounting. Banks can leverage the new accounting guidance to change the hedged exposure from wholesale funding to deposits without a re-designation event, allowing the bank to pay down wholesale borrowings. For those banks that now have many more deposits than when they first implemented the strategy, reducing their current need for wholesale funding, this is a welcome change in funding source that maintains the interest rate protection they continue to need.

The International Swaps and Derivatives Association Protocol

From an accounting perspective, ASC 848 allows banks to feel more in control of their hedge accounting fate. But what about the derivatives themselves? Last week, ISDA (International Swaps and Derivatives Association) announced that it will launch a protocol on October 23, 2020, to facilitate the necessary amendments to derivative contracts in advance of next year's transition away from "IBOR" indices. Swap users will have three months until January 25, 2021, to go onto the ISDA site and adhere to the Protocol. While the market is awaiting information on the specifics of the protocol adherence, this is what we know right now:

What are the main aspects of the Protocol?

The IBOR Fallback Protocol and IBOR Fallback Supplement: Update the ISDA definition of LIBOR, thereby incorporating proper LIBOR cessation fallback terms into existing LIBOR-based derivatives to ensure an orderly transition to the alternative reference rate. They also amend LIBOR fallback language in advance of the expected cessation of LIBOR at the end of 2021.

Simply put, for banks with existing derivatives contracts referencing LIBOR, choosing to adhere to the Protocol will enable the bank to amend the terms of those existing transactions to incorporate proper LIBOR cessation fallback terms in any derivative where they face another party that has also adhered to the Protocol. By adhering, the bank's existing LIBOR-based derivatives contracts will now be prepared for the LIBOR transition.

The protocol does not mean that the derivative transitions away from LIBOR immediately. Instead, the Protocol also defines what "cessation" events will set off this change in the derivatives. A LIBOR cessation is not expected until late 2021.

What happens if I don't adhere?

For a Protocol amendment to be effective, both parties to the transaction need to adhere to the Protocol via ISDA's website. If a bank chooses not to adhere, dealers will likely not trade more swaps with the bank. Banks looking to adhere after January 15, 2021, will be subject to a \$500 fee. Most importantly, the institution will have subjected themselves to a messy LIBOR polling process for their existing derivatives.

What will my LIBOR swaps transition to?

As of now, the plan is for the LIBOR swaps to transition to the relevant tenor SOFR, plus a predetermined credit spread.

Where can I find SOFR rates and the credit spread?

Bloomberg has been chosen as the calculation agent for the official ISDA IBOR fallback rates. Bloomberg users can go to "FBAK" on Bloomberg to see USD LIBOR Fallback rates and the official spread adjustments.

What Else is There to Consider Regarding LIBOR Transition?

In short, a lot. As far as the ISDA Protocol, there is much to explore regarding parties that do not wish to adhere to the Protocol, parties that wish to replace LIBOR with an index other than SOFR under ASC 848, and the proper way for banks with customer swaps programs to prepare for a LIBOR cessation. Of course, the LIBOR transition will have significant implications on banks outside of just their derivatives contracts. Ultimately, the right advisor will be important in helping to navigate these issues.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

Technology is at the forefront of senior bank executives' minds as winning new customers, increasing efficiency and managing risk, through the implementation of new technology, is core to their strategic plans. This was highlighted in the results of Piper Sandler's 1st Fintech Survey. Senior bank executives are steadfast in their commitment to grow and evolve their business through technology, although concerns around cost, return on investment, business interruption and interoperability with current systems can slow adoption.

As we endeavor to better understand our depository clients' views on Fintech, we have prepared our 2nd Fintech Survey - please see the link below. By clicking on the link, you will be taken to Survey #2 which builds on Survey #1 by gathering additional information on tech strategy, vendor selection and core banking systems.

This 5 minute survey can be filled out by any and all members of your senior leadership team and, when completed, will meaningfully contribute to our continuing efforts to provide unparalleled thought leadership and best-in-class advice.

Thank you in advance for taking the time to respond to this survey and we look forward to sharing our insights with you.

LINK TO SURVEY:

[Piper Sandler FSG Fintech Survey #2](#)

If learning more about our recent work is of interest to you, please don't hesitate to contact FSG-Solutions at FSG-Solutions@psc.com for more information.

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