LIBOR to RFR Transition

Developing a low risk, high value strategy & program

Part of the Evolving LIBOR series.

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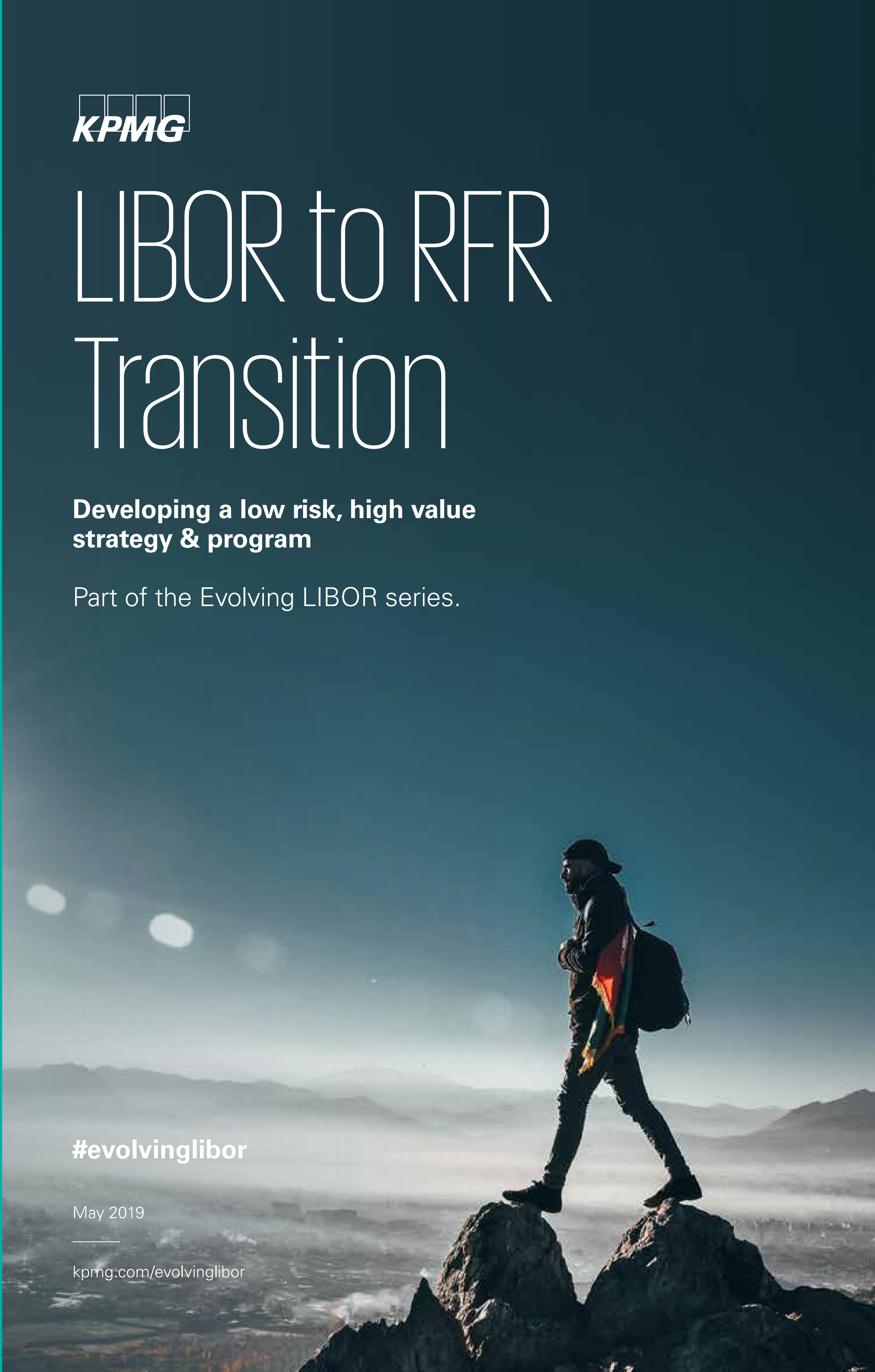


The end of 2021 is fast approaching - and marks when the London Interbank Offered Rate (LIBOR) may cease to exist. Now is the time to assess whether your organization will be ready for this seismic shift.

The transition is increasingly becoming one of the most complex post crisis transformation programs faced by financial services and its customers. With many pressing internal and external challenges and evolving timelines, firms are struggling to prioritize this transition.

The breadth of LIBOR's impact expands across many critical aspects of an organization. It touches on financing and transactions, clients and contracts, operations, systems, models, processes, and accounting. As firms start to look closely at the impact, more interrelated issues continue to emerge.

There are three key points need to be front-of-mind in the months ahead:

1 **Reliance on LIBOR is unsustainable, change is coming**

The availability of LIBOR beyond 2021 is uncertain - there is a possibility it will continue in some form - but global regulators have signaled that organizations should not rely on this and need to plan for the switch to alternative RFRs.

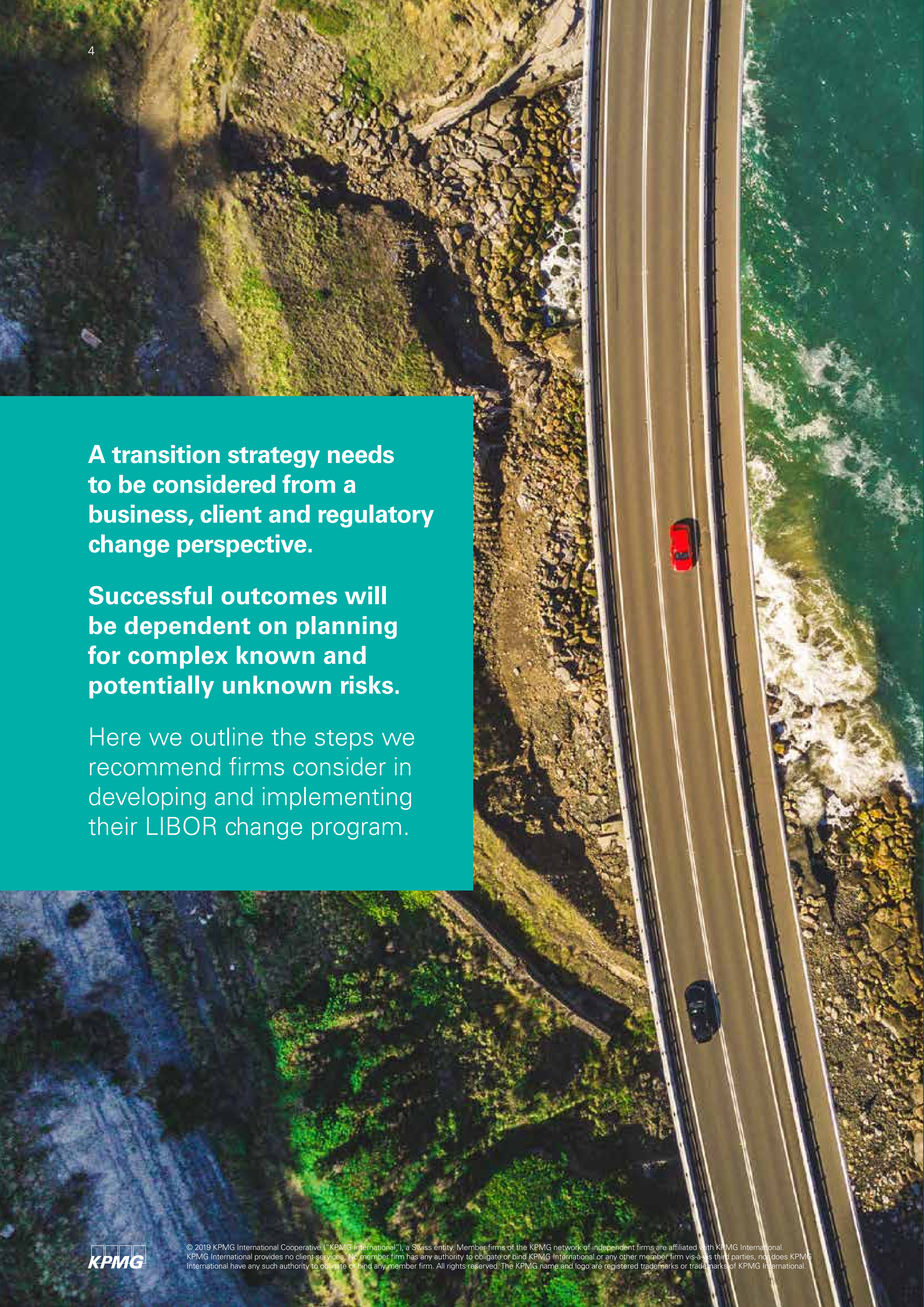
2 **The market must act collectively and purposefully**

The pace at which the industry can create markets, build liquidity and infrastructure for alternative RFRs, will directly impact the speed and success of the transition. For it to be successful, effective co-ordination is key with all parties.

3 **Understanding the variety and interconnectivity of risks is essential**

To meet the industry 2021 timeline, planning needs to be underway. The scale and complexity of this transition should not be underestimated.

A full understanding of the probable transition scenarios, firms key risks and the potential roadblocks is a key starting point. From this, a clear strategy for your firm can be developed to help ensure a smooth planned transition.



A transition strategy needs to be considered from a business, client and regulatory change perspective.

Successful outcomes will be dependent on planning for complex known and potentially unknown risks.

Here we outline the steps we recommend firms consider in developing and implementing their LIBOR change program.

Action steps towards a successful transition

Strategy

— Developing a strategy and guiding principles are important to align and drive the direction of the organization. Having a strategic vision will help guide and challenge the program in meeting successful outcomes overall.

— Some of the variables will be in your control (resourcing, approach, etc.), but many other variables are external factors (market protocols, regulatory actions, competitor product offerings, client requirements etc).

— Examples of strategic issues that may affect your approach include:

- What is your approach to industry and regulatory body engagement and advocacy?
- What is the role you want to play in developing the alternative reference rate market?
- When will your firm begin to trade in the alternative RFRs?
- What is your approach to franchise protection and seeking new business opportunities?
- How will you risk assess and prioritize clients, products and contracts?
- Is there an opportunity to differentiate yourself in the marketplace and do you want to?
- Will you leverage this transition to tackle other change programs within your firm (e.g. contract digitalisation, automation, simplification of models, data and processes).

Governance & program structure

— The establishment and coordination of governance guidelines, robust oversight teams, and the assignment of project ownership are critical initial steps in any transition effort. Establishing the proper centralized steering group, comprising senior sponsorship and representation from key business units and functions, is vital to ensure the right tone and senior engagement.

— This steering group must oversee the firm's effective transition strategy and plan.

— Choosing specific technical resources that can link together large complex change programs will be important.. These individuals will continually need to challenge the priorities, interdependencies and ensure the program is aligned to the business and client strategy.

New product development and liquidity

— Firms need to ready their ability to enter into cash and derivative RFR based products.

— Firms need to prepare to service their clients with these new products on a timely basis to enable sufficient time for the transition, liquidity develop and to support fallback clauses in legacy portfolios.

Assessing the impact

— As LIBOR rate is used and embedded in a vast array of financial products and operational processes, a critical element in the transition plan will be developing and updating a clear inventory of all the impacted issues.

— It is important to remember to review areas beyond an firms core products, and include the review of such areas as pricing models, funds transfer pricing (FTP), valuation models, accounting effects, tax considerations, and even procurement contracts.

Developing a robust communication plan

— A communication and outreach strategy needs to be developed and must consider:

- Clients: Be cognizant of conduct risk to both consumers and business clients.
- Internal eduction: Develop and implement an education plan to ensure consistent messaging and cascading of the transition strategy.
- Board of directors: Timely education and communication with board members will be imperative.
- Regulatory: Prepare to share your institution's comprehensive plan with regulators (e.g. Dear CEO letters).
- Industry bodies: Engage early and track outputs and agreed protocols.

Contract remediation and fallback language

— One of the largest potential efforts and risks will be identifying and modifying client/third party contracts. All contracts need to be assessed to determine which ones reference LIBOR and what, if any, fallback language exists in the contracts.

— The scale of the task in some organizations will all require the use of intelligent automation tools, such as KPMG Ignite, to digitise and interrogate the contracts.

— Legal assistance will be required to conduct an assessment of the fallback language and determine how contracts need to be adjusted. Organizations will need to understand if adequate legal resources are available to be dedicated to this effort.

— Even where fallback language exists in contracts, it may not truly contemplate this type of event and provide economic equivalence.

— The strategy for contractual negotiation and change will need to be included as part of a firm's wider business strategy and customer outreach plans.

— Are you today issuing new products with inadequate fallback language? It is important to stop the bleeding now as well and not cause additional contract modification work.

Data, systems and vendors

- How complete and readily available is the institution's data?
- The quality of legacy data from prior acquisitions, multiple systems, and decentralized locations all will contribute to LIBOR transition program challenges.
- LIBOR transition can be used as a catalyst to build out a stable data set and streamline existing systems.
- Does the institution have the tools to sweep the code to find the LIBOR/reference rate occurrences? Identifying and assessing EUCs for LIBOR impact might prove to be quite a challenge.
- Have you identified dependencies/reliance on vendors for the vendor supported systems and applications?
- Are your vendors doing the same assessment and are you tracking their progress

Models

- The devil is in the detail - there is a wide spectrum of models used throughout your organisation that have reference-rate inputs. Assessing all models and creating an inventory may take a considerable amount of time from specialized resources.
- If hundreds of models need to be changed, duplicated for multiple rates, and/or retired, how would these activities fit into your model-development planning and model-risk-management review activities?
- Certain models will require regulatory approval for significant changes. The time to obtain regulatory approval will need to be built into a firm's overall transition timeline.

Finance, accounting, and treasury

- Many finance activities may be impacted by by transition. Some examples may include pricing committee activities, balance-sheet management, accounting-valuation assessments and FTP activities.
- Understanding all of the existing hedge relationships and how they were documented will be essential.
- Hedge accounting will be a significant issue to consider. A change in the critical terms to one side of the hedge may result in termination, thereby causing a de-designation of the associated hedge relationship.
- Debt agreement changes could trigger debt modifications or defined as a debt termination — and each could have important accounting impacts.
- New reference rates may change discount rates used in many models, including those used for capital calculations, valuation and impairment testing.

Tax liability impact

- The discussions should include both analyzing the tax impact the LIBOR change could have on the organisation's debt and non-debt contracts, as well as reviewing the steps the organisation is considering to manage the cessation of LIBOR.
- Tax departments should continue to monitor whether guidance is released by the major jurisdictions that provides clarity regarding how the cessation of LIBOR, and transition to new rates, is treated for tax purposes.

Risk management readiness

- Risk-management teams and assessments should be included throughout the process from impact assessment through to execution of the LIBOR transition strategy.
- Developing specific assurance programs to assess the progress of the transition program will be essential to support senior management.

One eye on the market - benchmarking

- One thing will be certain, the market will continue to evolve.
- We believe most institutions are in the early innings of the LIBOR transition journey, and many factors will weigh on the transition in the months ahead, including:
  - Regulatory expectations: Will regulators ask for periodic updates on an institution's plans?
  - How will marketplace pricing and liquidity change as we move closer to 2021?
  - How will clients react to changes in products and perceived pricing?
  - When is the right time to transition your backbook? Will competitors leave you behind in offering new RFR products earlier ?

A review of action steps to consider

As the timelines and industry protocols develop, there are some important no regrets actions that organizations should undertake in preparing for the wider implementation:

1

Tracking and supporting the industry protocols.

2

Preparing the initial impact assessment of the back book of IBOR based trades covering exposures, infrastructure and more contracts.

3

Developing new RFR based product capabilities. Supporting the developing liquidity of new RFR products.

4

Communicating with clients and understanding their needs and impediments to transition.

Unlike many other regulatory change initiatives, the impact assessment will need to revisited as the program evolves and new issues emerge. There are a significant number of interrelated issues that will need to be linked up and coordinated as contracts are amended, new product capability is built out and infrastructure enhancements finalized. The sequencing of changes will need to be carefully worked through and planned.

One thing is certain — any initial strategy and plan will need to change and evolve. It will be important to be aware of the evolving external market and regulatory expectations. As a result, programs will need to adapt and remain nimble as the transition moves through to 2021.

LIBOR Navigator

KPMG's transition framework

KPMG Ignite

KPMG's artificial intelligence platform.

Ignite is an integrated platform of open source tools, KPMG-developed IP, frameworks, patterns, and leading technologies supported by our alliance partnerships.

Who

A platform for Data Scientists and Engineers.

- Designed to enable Data Scientists and Engineers to build AI solutions from prototype to industrialization ready
- Designed to integrate with SME expertise and business knowledge

What

A global AI platform with a modular component architecture.

- A development platform that creates the ability to dynamically leverage the best "AI-tool" for the job
- A modern AI architecture that supports API and container based deployments
- Enables the reuse of previously built models and collected domain expertise to maximize data science efficiency

Why

Unlocks the value of unstructured data with surgical precision on complex problems.

Encourages and enables reuse for scale.

- Handles challenging data sources – documents, images, voice, etc.
- Enables KPMG to build custom, quality, production AI solutions

KPMG Ignite Deployment Options

There are several deployment options available, in order to cater to a client's specific need, scope, size and business challenge.

Option 1

One-time Service/Analysis

Bespoke, one-time service / analysis and reporting.

One time services / analysis leverages a Laptop and Single Server Platform (For prototyping, development and proof-of-concept)

Option 2

Analytics as a Service

Provide "ongoing analysis", as a service, hosting solutions on our infrastructure.

Leverage KPMG Infrastructure (For prototyping, development and continuous analytics delivery)

Option 3

Custom Solutions

Build custom solutions, deploy on cloud or client's infrastructure.

Utilize pre-built solution-specific options or develop a new custom solution.

Option 4

Complete AI Platform design and implementation

Enable the client's AI by building the Ignite Platform for their Data Scientists.

Deploy large-scale or production Ignite-like AI Platform, and serve results through a User Interface or API. Rapid containerized deployment, with security-reviewed architectures.

Example KPMG Ignite Solutions

Our solutions can be customized to handle different requirements around input, analysis and results to ensure the solutions meets the needs of the business

Cognitive Contract Management

AI-enabled contract management provides a enhanced approach for contract review, assessment and management

Intelligent Forecasting

Accurate forecasts created automatically through machine learning and external signals

LIBOR Analytics

AI-enabled interpretation and amendment of LIBOR based agreements

Qualified Financial Contract (QFC) Analytics

Rapidly review massive volumes of documents, accurately, for compliance purposes

Cognitive Vouching

AI-enabled extraction and comparison of key attributes from various document types for audit procedures

Cognitive Transfer Pricing

AI-powered identification of comparable companies for benchmarking

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