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| Whitepaper

How to leverage the LIBOR transition to improve your data management game

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INTRODUCTION

The final goodbye to Libor has been described as the Y2K moment for data managers in financial services – and with the phase-out slated for the end of 2021, firms need to act now to ensure a smooth transition.

The replacement of Libor with alternative benchmarks presents an immense data management challenge for financial institutions, especially given the ambiguity that remains around execution of the final stages of the transition. On the other hand, practitioners suggest that getting it right could be a catalyst to operational improvement, giving firms the impetus to address major data quality, governance and management issues, allowing them to better understand their data and reorganise their approach to gain competitive advantage in a crowded field.

This paper explores what the discontinuation of the interbank rate as a benchmark really means for the industry, and where firms are with their efforts to replace it. It examines some of the available alternatives and how they differ in terms of structure, as well as looking at what firms should be doing to address risk both during and after the transition.

Finally, it looks at the steps that firms can take to coordinate data management approaches to ensure efficiency and future proofing, and how applied technology such as automation, analytics and other innovations can assist during the transition.

THE CURRENT STATE OF PLAY

Despite the current coronavirus pandemic, regulators have remained steadfast in their assertion that the transition will go ahead according to schedule. The UK Financial Conduct Authority (FCA) has remained firm on its commitment to phase out Libor by the existing deadline, warning in an April 29 statement that "firms cannot rely on Libor being published after the end of 2021."

Although the regulator recognises the challenges presented by the current operating environment under Covid-19, the statement notes "continued progress" in the marketplace. This includes the first syndicated loan that will link to alternative benchmarks Sterling Overnight Index Average (SONIA) and Secured Overnight Financing Rate (SOFR). The market has also seen a successful consent solicitation to convert a legacy Libor referencing bond, while within sterling cash markets, transition to SONIA in the bond market has been largely completed.

The Working Group on Sterling Risk-Free Reference Rates (RFRWG) confirms that by the end of Q3, 2020 lenders should be in a position to offer non-Libor linked products, while all new issuance of sterling Libor-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021.

THE INDUSTRY RESPONSE

Libor is the world's most widely-used benchmark, providing a reference rate for short-term interest rates, ranging from overnight to one year, across many different currencies. Influential as a reference rate for financial contracts as well as a benchmark to gauge funding costs and investment returns for a broad range of financial products, it plays a critical role in global financial markets and its phase-out affects the entire banking community and financial services marketplace.

The key Libor alternatives are currently SONIA in the UK, and SOFR for US dollar transactions – although there are other rates proposed in other markets, which may complicate transitions further. And since none of these are not like-for-like replacements, all securities and applications have to be comprehensively reviewed and updated to ensure that they move correctly onto the new benchmark.

An automated inventory and data lineage can help with this, giving firms the ability to forensically determine which applications depend on Libor rates, identify the financial exposures and the end-to-end downstream impact, and inform the approach to transition. The back book and legacy trades must then also be transitioned, Libor switched off, and the underlying infrastructure moved over to the new benchmark rate. On top of this, risk factors for implementation must also be identified in order to estimate potential impact.

A data intelligence (with smart glossary, inventory and data lineage) approach can help provide a forensic overview of what is needed, but the process is a long one with some of the more advanced firms taking up to six months to complete – and that is only the beginning. Doing this manually for everywhere the Libor rates exist today would be difficult, especially given that many of the subject matter experts that first developed the processes around these rates may have moved on to other positions or other companies. Automation is essential to enable rapid search and impact analysis across the systems and lines of business.

It is hard to underestimate the magnitude of the impact of the transition, which many have compared to Y2K (the Millennium bug that was widely expected to induce worldwide software meltdown as computers switched from the year 1999 to 2000) in terms of its pervasive impact and severe penalties for error. If firms cannot manage a timely transition, this could lead to loss of business and reputational damage if contracts cannot be fulfilled.

In order to make the switch away from Libor, banks must look at every single system and application they own, including every underlying database and dataset, underpinning every contract and every security.

While some banks have made a start on contract remediation (the 'paper' part of the problem), the broader data impact is going to be far wider. Firms will need, for example, to create new models for pricing using the new benchmarks, creating new credit risk spreads, and evaluating how that will affect margins and profitability – and far fewer firms have yet reached that point.

According to a recent poll by A-Team Group, very few firms are actually anywhere near achieving transition despite the fast-approaching deadline – with less than half (45%) on track with their transition plans and a quarter (25%) identifying themselves as "struggling," while just under one-third have not even started their strategy yet.

The importance of due diligence

One of the most important elements in any data management strategy has to be incorporating the difference between Libor and the new so-called risk-free rates (like SONIA and SOFR), which differ structurally from Libor and therefore have technology and data implications for firms seeking to use them.

At its heart, the issue is that moving to risk-free rates is not a "one to one, find and replace" process. Practitioners must augment their Libor pipes and re-pipe with data and processes for performing the required calculations. From a data perspective, this means firms may not only have to pipe new data into their models, but the way they treat the output of those models may also change. The transition of this complex data journey requires robust and comprehensive inventory analysis and data lineage capabilities, if firms hope to be able to identify, interpret and respond to their new requirements effectively.

So how can firms assess the risk inherent in current Libor-based products, and how should they approach re-evaluation of those risks during and after transition?

It is vital for an organisation to implement due diligence around the impacted areas, in a project that must be carefully orchestrated across the whole enterprise. Firms should look to create an end-vision of what they want to achieve, along with an overall understanding of where they are today and how they are going to get from Point A to Point B, across all their disparate business entities.

This is where analytics and modelling have a key role to play – especially in terms of creating a tracking mechanism for the process, establishing a centralised location for the information, and snapshotting how the project evolves. When doing due diligence, firms should track the baseline of their Libor readiness, as well as tracking the data supply chain from Libor rates within their various business entities. Tools such as dynamic maps can help act as a program accelerator in this process, to ensure both speed and accuracy.

A coordinated approach is imperative

According to a poll from A-Team Group, the biggest impediment to the Libor transition is the lack of a unified approach – with 63% of respondents identifying this as a key challenge, compared to 16% citing cost, and others mentioning lack of clarity, uncertainty around the regulations, and lack of senior management support.

Overall, however, the most important element for success must be a coordinated approach across all lines of business, based on an initial vision of where the firm wants to be and how it plans to get there, leveraging efforts to coordination data management approaches and ensure operational and cost efficiency as well as future-proofing any changes. In this respect, an intelligent data management solution is required to play across all technology and line of business borders. A glossary or data catalogue alone will not expand to everywhere Libor codes exist today to give you that inventory and impact analysis.

Forward lineage beginning in a legacy system is important, enabling the firm to identify how and where rates are stored and then track their transition and transformation process through warehouses and lakes – from point of production to point of consumption. It is important to have this built out, as a priority, so that it can be handed off to the various technology and business owners, and data governance leads, so that they can understand the overall impact. It is only by doing this, that business and risk leaders can begin to formulate a program to move forward. And once this framework is in place, practitioners can then begin to initiate multiple logical units of work to remediate and instantiate it.

IMPLEMENTING A SOLUTION

Firms need to identify the gaps in their data, understand where the impact will be and where they are at risk, and engage with data architecture and IT infrastructure to put an urgent plan in place that will meet the timeframe. The latest A-Team Group poll shows that almost half (48%) of firms are seeking to handle the transition in-house, while almost a third (28%) are looking to repurpose an existing system. Almost one-quarter, however, are looking to third-party solutions – including 16% who plan to purchase something and 8% who have already bought a product from a third-party vendor.

Inevitably, clients with in-house solutions are moving ahead faster – meaning that those seeking external assistance need to move fast in order to catch up. The wide range of solutions could cover data catalogues, data discovery, data glossaries, data lineage tools, content systems, modelling tools, and more.

Whichever you choose, there are some features that firms may wish to consider when it comes to product purchase, that will enhance their ability to effectively manage the transition process.

The first is automation – specifically, the ability to automate the discovery of where Libor bar codes exist, whether in applications or mainframes or ERP systems. Using manual and project-based efforts to find and track Libor rates is inefficient, especially considering that the SMEs who established the codes in the legacy systems in the 80's and 90's may not be around.

The second is the use of artificial intelligence, which has developed rapidly in the field of data lineage and discovery. For example, a recommendation engine could achieve a higher rate of intelligent matches, as well as helping to find and track new rates going forward.

Finally, intelligent impact analysis is another area to look at. Intelligent analysis should deliver both vertical and horizontal views, giving you a tangible connection between the business and the technical aspects.

A CATALYST FOR DATA MANAGEMENT NIRVANA?

The nature of this transformation is exceptionally complex, and there is an enormous amount of work to be done around the data libraries, critical data elements and business rules alone, simply to understand the ecosystem, before any plan can be formulated. Understanding this data, however, can give firms an edge going forward that, if continued, could be of business benefit.

Over the last two decades, the question within the data management function has always been: "What will be the catalyst for us to put in place all the governance processes needed to truly clean and streamline the data." The Libor transition could be that kickstart the industry has awaited for so long, by requiring firms to identify and analyse a wide range of applications, and translate them through a regulatory prism.

Firms must document data provenance from the point of production to the point of consumption – resulting in a framework of information that is highly leverageable. And once this has been solved for the Libor element, and built those cross-enterprise structures to track critical data elements, firms are already in a strong position to solve it for other critical data elements as well.

Building out data lineage is an ongoing process, for which there is no magic bullet. But capturing information on an ongoing basis has undeniably beneficial prospects for the future – and an effective data lineage tool and data catalogue can help you identify, remediate and triage future errors.

So despite the enormous data management challenge that the transition represents, it could also be viewed as a building block, with which you can achieve not only greater control of your data, but a better understanding of that control, and how it can be leveraged to achieve cost savings and commercial benefits.

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