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Why aren't you in a blue funk?

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A question that more people need to be asking themselves these days is: "Why then hell aren't you in a blue funk?"

And no, it's nothing to do with Coronavirus… that was last week's breathless editorial – followed by IJGlobal spending most of this week postponing pretty much all our plans until summer because of Covid-19 – so no, it's not something we want to talk about today!

The focus of this week's missive is the financial time bomb that's ticking with increasing urgency towards the end of 2021 – a mere 665 days away – by which time the entire financing community had better have their houses in order.

Yes, today we return to the dilemma of transitioning from established inter-bank lending rates towards something that global regulators deem to be more challenging for pesky bankers to manipulate.

It was last June that IJGlobal first pointed a trembling finger at the Herculean Task facing commercial lenders who have to transform their loan books from established base rates, replacing them with alternative reference rates (ARR) – risk-free rates (RFR).

Given the scale of this challenge of which infrastructure and energy is merely the tip of a global iceberg, it remains a source of continuous wonder to this infra hack that it's not cropping up more frequently in conversations.

Furthermore, given that it transcends the entire financing community and that Libor (and all reference rates) forms the basis for pricing on hundreds of trillions of dollars of financial instruments… you'd think it'd – you know – be at the front of people's minds.

The alternative reference rates being bandies around are many, and while Libor is the one that should have most IJGlobal readers reaching for a double GNT, it's across the board.

On the oche at the moment are:

- UK: Sterling overnight index average (SONIA) – administered by Bank of England
- Europe: Euro short-term rate (ESTER or €STER) – European Central Bank
- US: secured overnight financing rate (SOFR) – Federal Reserve Bank of New York
- Japan: Tokyo Overnight Average Rate (TONAR) – Bank of Japan
- Switzerland: Swiss average rate overnight (SARON) – SIX Exchange
- Canada: Canadian overnight repo rate average (CORRA) – Refinitiv Benchmarks Services
- Australia: interbank overnight cash rate – Reserve Bank of Australia

Cool as a cucumber

Taking a stroll through the IJGlobal database the numbers – while they need to be viewed in a slightly circumspect manner given the passage of time – there's enough in it to set your hair on end.

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Here follow commercial loans logged on our system from 2005 until 2020 (year to date) lent against infrastructure and energy:

- **Project Finance** total – US$2,396,672 million
  - 2005 to 2010 – $164,790 million
  - 2010 to 2015 – $1,074,675 million
  - 2015 to 2020 (YTD) – $1,157,208 million
- **Corporate Finance** total – $2,092,578 million
  - 2005 to 2010 – $70,450 million
  - 2010 to 2015 – $553,605 million
  - 2015 to 2020 (YTD) – $1,468,523 million

While that may pale into… well… not insignificance against the hundreds of trillions of dollars in financial instruments – ranging from derivatives and commercial loans to mortgages – it's still a pretty hefty figure.

Talking to people around the industry sensing their mood surrounding changes to reference rates, responses range from positively blasé as they casually kick the can down the road… to decidedly discombobulated, likely to start waving banners in Piccadilly Circus declaring the End Is Nigh.

While reality lies somewhere between the two, it seems prudent – given the timeline – to lean towards the nervous end of that scale.

A balanced perspective

Every loan that has been signed and sits on the books of a commercial lender has a base rate – and every single one of them is going to have to change… a massive exercise in itself and a logistical nightmare.

Those of us with enough grey hairs to remember 2008 will well recall that working out just how much is deployed and where is not the easiest job a bank can conduct (curious, but true).

Each of these loan documents will need to be amended to reflect the new benchmark and negotiating each of these changes will take blood, sweat, tears and legal fees.

There is a credit-risk premium and a time-risk premium. The likes of Libor – a forward-looking rate – will have to be switched to overnight rates that (if anything) are backward-looking rates.

Chris Brown, who has been immersed in Libor transition since taking over as head of banking at Norton Rose Fulbright around two years ago, views this as a "seismic event"… and quite right too.

"There is a massive exercise to be done," says Chris. "And for a long time, I fear the finance world has thought it was going to be kicked down the road, but the regulators now – certainly the UK and the US – are making it very clear that they will be replacing these benchmarks.

"We have detected that banks in continental Europe are a little more relaxed about this as Euribor will continue, but their regulators are encouraging them towards alternatives and I believe it will go the same way as Libor, and they will disappear."

From numerous discussions this weeks with infra/energy lenders and advisers, minimal resource is being devoted by lenders to resolving this issue in time for the end of 2021 which in turn will likely create a degree of volatility in the market.

"If you look at project finance transactions," says Chris. "You know at the beginning of the interest period the rate of interest that you will pay....towards the end of that period what that rate is going to be unless a new financial instrument is devised to fix the rate for the interest period."

Given all that, how can anyone be relaxed to the point of unconcern?

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People – the panic button is there for a reason.

Those who are looking at this as an issue that is to be dealt with from the start of next year would do well to take the time they now have on their hands – given everyone now seems to have travel bans – and start the process today… rather than wait until 2 January 2021.

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