INTUITION

# Learning Insights

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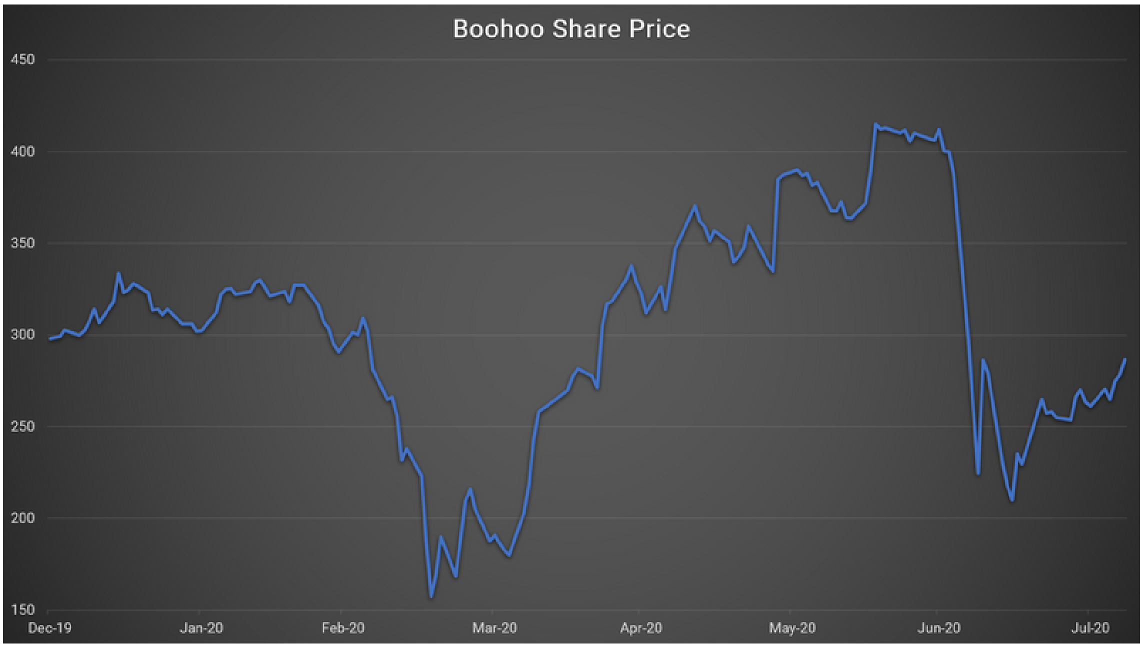
As LIBOR Deadline Looms, Low SOFR Swap Volumes Threaten Efforts to Build Term Rates

# ESG Reporting Revolution – Firms Must Grapple With The Need For Real Numbers

**As socially responsible investing (SRI) became increasingly important to investors, many companies began to produce glossy annual sustainability reports. However, those reports often offered style over substance and a lack of widely accepted reporting standards meant that many companies were able to avoid unpleasant disclosures. In January, a bold letter to CEOs from BlackRock CEO Larry Fink promised to change this, forcing companies to engage meaningfully with the need for environmental, social, and governance (ESG) disclosures.**

In today's investment environment, ESG matters. But too often, investors struggle to find the information they need to manage ESG risks in their portfolio.

Consider the following cautionary tale. In July, fast fashion retailer Boohoo saw its share price plunge. The retailer had been enjoying a rally following the broad market selloff of the first quarter. Then allegations about the working conditions and wages of the workers in its UK supply chain sent the share price crashing. The stock has since regained some lost ground, but Boohoo faces significant challenges including a social media backlash, threats of government enforcement action, and suspensions from various fashion websites.




*Source: Yahoo! Finance. Boohoo share price. August 2020.*

What is most striking about the Boohoo story is that its shares were major holdings in many prominent SRI funds, which apparently relied on positive ratings from ESG rating agencies such as MSCI – the agency gave Boohoo an AA rating in June – to justify its inclusion in their portfolios.

This story highlights the fact that current ESG reporting standards often fail to provide the information needed to make accurate SRI decisions. Change is urgently needed.

## Enhanced disclosure

When Blackrock CEO Larry Fink penned his now-famous letter to CEOs in January, he emphasized disclosure as a core issue in the transition to sustainable economic development. Without clear, accurate, reliable, and comparable data about companies' ESG performance, it is impossible to identify truly sustainable businesses and distinguish them from poor-performing peers.

According to Fink, while it is challenging to provide quality data on some ESG issues, enormous global efforts have been made to develop useful and meaningful ESG reporting standards.

Blackrock recommends – and indeed, now demands – that its investee companies look to the guidance contained in the Sustainability Accounting Standards Board (SASB) standards and the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).

**What are the SASB standards?**

The SASB standards are focused on financially material information that is primarily relevant to investors. They were developed to help companies provide structured, comparable, financially material information in mandatory filings such as the 10-K.

SASB divides companies into categories using its Sustainable Industry Classification System® (SICS®), which groups businesses into eleven sectors and then into 77 industries. Each industry can then use an industry-specific SASB standard to report on the financially material issues that affect them.

While acknowledging that developing robust ESG reporting frameworks is a challenge, Fink wrote: "This year, we are asking the companies that we invest in on behalf of our clients to: (1) publish a disclosure in line with industry-specific SASB guidelines by year-end, if you have not already done so, or disclose a similar set of data in a way that is relevant to your particular business; and (2) disclose climate-related risks in line with the TCFD's recommendations, if you have not already done so."

**What are the TCFD recommendations?**

TCFD's various disclosure recommendations are organized into four categories.

- *Governance* – Companies should disclose their governance around climate-related risks and opportunities (CRROs).
- *Strategy* – Companies should disclose the actual and potential impacts of CRROs on their businesses, strategy, and financial planning – where such information is material.
- *Risk Management* – Companies should disclose how they identify, assess, and manage climate-related risks.
- *Metrics & Targets* – Companies should disclose the metrics and targets they use to assess and manage relevant CRROs – where such information is material.

Although Blackrock's expectations will only directly affect the companies it invests in, given its status as the world's biggest asset manager, its reporting requirements will indirectly affect the behavior of companies worldwide.

**Time for change**

As businesses grapple with the impact of the coronavirus pandemic and the global economic crisis, some corporate leaders argue that tough external conditions make the need for robust ESG data relatively less important. But as the Boohoo case demonstrates, rather than diminishing the importance of ESG considerations, the crisis has in fact enhanced investor concerns about firms that misbehave.

Therefore, despite the many challenges facing businesses, it is time for companies to begin providing the robust and reliable ESG data that investors truly need.

**Intuition Know-How has a number of tutorials that are relevant to ESG and reporting:**

- ESG & SRI – An Introduction
- Corporate Governance
- Corporate Social Responsibility (CSR)
- ESG & SRI Reporting (*Coming Soon*)
- ESG & SRI Primer (*Coming Soon*)
- ESG & SRI – Investing (*Coming Soon*)
- ESG Factors (*Coming Soon*)
- SRI Strategies (*Coming Soon*)
- Green Assets (*Coming Soon*)

# As LIBOR Deadline Looms, Low SOFR Swap Volumes Threaten Efforts to Build Term Rates

**LIBOR, which serves as a reference rate for over $300 trillion of global financial contracts, is scheduled to be phased out by the end of next year. At that time, financial contracts will need to transition to new reference rates, with potentially major impacts on a range of markets. While significant progress has been made in identifying and developing alternative reference rates (ARRs), crucial gaps remain as the deadline approaches. In US markets, for example, delays in the development of forward-looking term rates pose a potential challenge for a range of financial contracts.**

Once hailed as “the world’s most important number, the London Interbank Offered Rate (LIBOR) will – barring the unforeseen – be discontinued at the end of 2021. At that point, new financial contracts will reference the relevant ARRs, such as the Secured Overnight Financing Rate (SOFR) in the US (see table below for details). Most of the ARRs are risk-free rates based on transaction data from highly liquid overnight markets, making them more robust and less vulnerable to manipulation than LIBOR.

| Jurisdiction | Relevant LIBOR Rate | Replacement Reference Rate | Type |
|---|---|---|---|
| United States | USD LIBOR | Secured Overnight Financing Rate (SOFR) | Overnight repo collateralized by US Treasury securities |
| United Kingdom | GBP LIBOR | Reformed Sterling Overnight Index Average (SONIA) | Unsecured overnight sterling |
| European Union | EUR LIBOR | Euro Short-Term Rate (ESTER) | Unsecured overnight euro |
| Japan | JPY LIBOR | Tokyo Overnight Average Rate (TONAR) | Unsecured overnight yen |
| Switzerland | CHF LIBOR | Swiss Average Rate Overnight (SARON) | Overnight Swiss franc repo |

On the face of it, this sounds simple enough. Unfortunately, however, there are some significant complexities involved in the transition away from LIBOR.

## Roadblocks on the way to a post-LIBOR world

Hundreds of trillions of dollars of existing contracts reference LIBOR. The parties to these contracts must all agree on a strategy for transitioning to new reference rates. Global organizations such as the International Swaps and Derivatives Association (ISDA) have developed standard language for insertion in contracts, but the process is slow and there are many unanswered questions outstanding.

Among those, a major issue relates to forward-looking term rates. Many loan contracts, for example, have historically used forward-looking LIBOR rates to determine future payouts. The ARRs, as noted, are generally backward-looking overnight rates (calculated the morning after the day on which the transactions occurred). As such, they are a poor fit for the needs of many types of financial contract.

The regulatory bodies overseeing the LIBOR transition have proposed various alternatives to overcome this limitation. In the US, for example, the Alternative Reference Rates Committee's (ARRC) suggestions include:

- **SOFR compounded in advance:** This would mean using the ARR, compounded for the terms occurring ahead of the interest period – generally one, three, or six months – to match the length of the relevant interest period. So, for example, for a one-month interest period beginning on January 1, the compounded rate would be calculated for the month of December. This approach would give the parties to the contract certainty about what interest would be due. However, the rates in question would be stale – they would apply to the period preceding the interest period rather than the interest period itself. This exposes the parties to changes in interest rates.

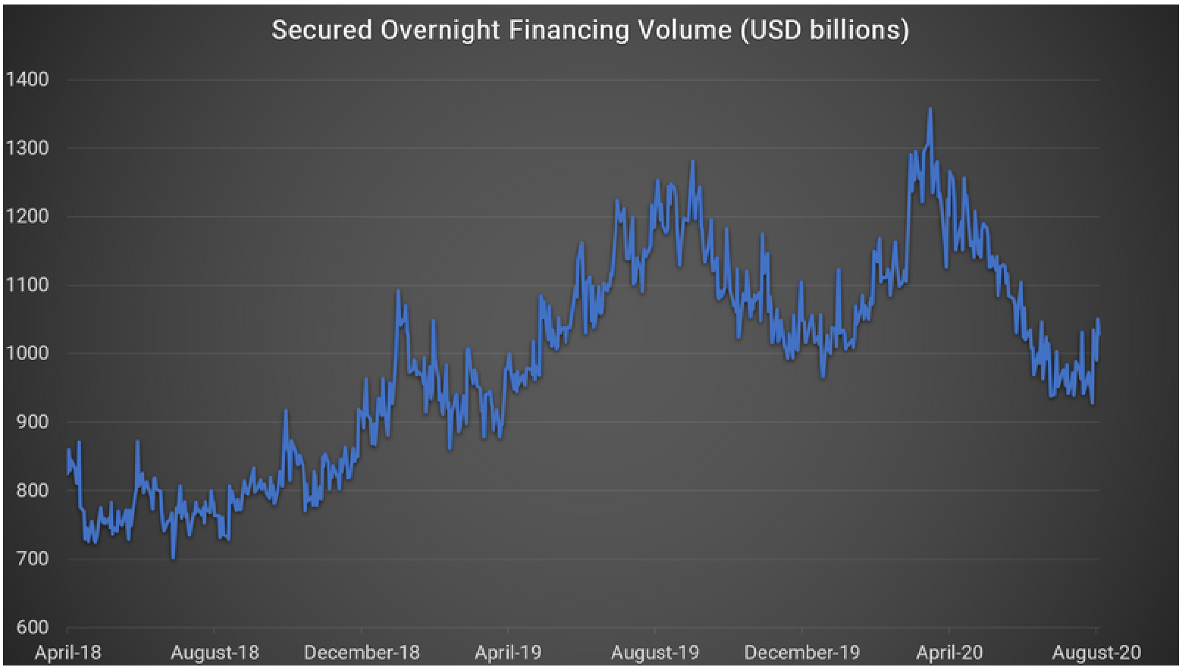
- **SOFR compounded in arrears:** This would mean using the ARR, compounded during the relevant (current) interest period. So, for example, for a one-month interest period beginning on January 1, the parties would compound the daily SOFR rate each day from January 1 to January 31. This approach ensures that the interest rate reflects the prevailing rates during the relevant period, rather than historical or projected rates. The derivatives market is likely to adopt this approach, so its use would also make loan or other contracts compatible with any hedging instruments. The problem, however, is that the interest rate will only be known at the end of the interest period. This may pose a challenge for borrowers, who won't be able to plan for payments as they won't know what those payments will be until they are due. It also means that borrowers won't know the actual cost of their borrowing before the conclusion of the contract.

While these solutions may work for many financial products, for instruments where issuers need visibility on their payment amounts, like floating rate bonds and bilateral business loans, forward-looking term rates are recommended.

Accordingly, regulators have invited benchmark providers to develop official forward-looking term rates for the various ARRs. Firms such as CME, Ice Benchmark Administration (IBA), FTSE Russell, and Refinitiv have all prepared to submit bids, using different methodologies to arrive at proposed term rates.

In some markets, progress has been swift. In the UK, for example, a forward-looking SONIA term rate will soon be available in a beta form. In the US, however, the development of a term SOFR rate has been hampered by low SOFR swap volumes.

While the volumes in the overnight Treasury repo market that underlies the daily SOFR rates are high, SOFR-linked derivatives volumes have grown more slowly than anticipated. According to ISDA, just $253 billion notional of SOFR swaps traded in the first half of 2020 – accounting for less than 1% of the $36 trillion in dollar LIBOR swaps traded during the period. In contrast, ISDA reports that SONIA swaps traded some $8 trillion notional in the first quarter of 2020. The relatively slow development of the SOFR swap market has made the task of developing a SOFR term rate – which the ARRC expects to incorporate data from the swaps market – a challenge.




*Source: Federal Reserve Bank of New York, August 2020.*

Despite this, data providers hope to have their SOFR term rates available in the first half of 2021. Many are anticipating a surge in SOFR-linked derivatives volumes in the fourth quarter – LCH and CME are scheduled to switch to SOFR discounting for future cash flows on cleared US dollar swaps in mid-October, and it is hoped this will boost trading. Should this surge materialize, providers will be able to create robust term rates by early next year.

While optimists hope that a SOFR term rate will be available well ahead of the LIBOR deadline, some officials at the ARRC have urged market participants not to pin their hopes on a term rate but instead to use SOFR compounded in arrears. For contracts where this approach is unsuitable, however, the development of a SOFR term rate is becoming ever more urgent.

**Intuition Know-How has a number of tutorials that are relevant to swaps and benchmark rates:**

- Money Markets – An Introduction
- Interbank Market
- Swaps – An Introduction
- Swaps – Applications
- Swaps Applications for Corporates – Scenario
- Swaps Applications for Institutional Investors – Scenario
- Swaps – Impact of the Financial Crisis
- Interest Rate Benchmarks – An Introduction (*Coming Soon*)
- Interest Rate Benchmarks – Applications (*Coming Soon*)