The transition from LIBOR

By Paul Richards

Summary

As background for ICMA members, this Quarterly Assessment introduces some of the issues that need to be addressed in implementing the transition from LIBOR to near risk-free rates, in six main sections: the future of LIBOR; the introduction of near risk-free rates in place of LIBOR; the differences between secured and unsecured reference rates; the differences between overnight and term rates; transition issues relating to legacy financial instruments; and transition issues relating to new financial instruments.

Introduction

1 Benchmark reform is a global issue. The Financial Stability Board, which has overseen global benchmark reform since 2014 drawing on IOSCO's earlier work, has called for the development of near risk-free rates for use as alternatives to the London Interbank Offered Rate (LIBOR) and other similar IBORs.[1] LIBOR has been regulated by the FCA since April 2013.[2] The FCA's Chief Executive, Andrew Bailey, set a deadline for the transition from LIBOR in a speech on 27 July 2017, in which he said that the current panel banks had agreed voluntarily to sustain LIBOR until the end of 2021, but that the FCA would no longer intend to use its powers to persuade or compel banks to submit contributions for LIBOR after the end of 2021.[3] Nor does the EU Benchmark Regulation, which came into effect in January 2018, permit the FCA to compel banks to submit contributions indefinitely.[4]

2 In the case of many LIBOR benchmarks, the underlying market which LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is not sufficiently active. Consequently, there is not a sufficient number of observable transactions, with the result that panel banks submitting transactions data need to rely on expert judgement. In the FCA's view, it is potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them.[5] Many panel banks are themselves reluctant to provide submissions which are based on judgement rather than actual transactions data, given the potential risk this creates. LIBOR will not necessarily cease to exist at the end of 2021 – that will be a matter for the IBA and the panel banks – but publication of LIBOR will no longer be guaranteed. The market therefore needs to plan for an orderly transition away from the use of LIBOR to one or more alternatives.

The future of LIBOR

3 In financial markets globally, it is estimated that the value of contracts referencing LIBOR is roughly $350 trillion on

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1 See: FSB: *Reforming Major Interest Rate Benchmarks,* July 2014. In the 2014 report, the FSB made recommendations for enhancing existing benchmarks for key IBORs in the unsecured lending markets, and for promoting the development and adoption of near RFRs where appropriate. See also: the Wheatley LIBOR review, 2012; IOSCO: *Principles for Financial Benchmarks,* 2013; IOSCO: *Guidance on Statements of Compliance with the IOSCO Principles for Financial Benchmarks,* 2016; IOSCO: *Use of Financial Benchmarks, 4 December 2017.*

2. ICE Benchmark Administration (IBA) is the administrator of LIBOR. 20 panel banks submit contributions to the benchmark. IBA and the LIBOR submission process are regulated by the FCA.

3. Andrew Bailey, Chief Executive of the FCA, *The Future of LIBOR:* Bloomberg, 27 July 2017. The FCA confirmed on 24 November 2017 that all 20 of the panel banks have agreed to support the LIBOR benchmark, ensuring the sustainability of the rate until 2021.

4. The EU Benchmark Regulation was published on 30 June 2016, and is fully applicable from 1 January 2018.

5. Andrew Bailey, Chief Executive of the FCA: *The Future of LIBOR:* Bloomberg, 27 July 2017.

a gross notional basis. LIBOR is quoted in five different currencies: sterling; US dollars; euro; Swiss francs; and Japanese yen. Derivatives represent much the largest proportion of market exposure when calculated on a gross notional basis. In the cash markets, the main financial instruments referencing LIBOR include floating rate notes, syndicated loans and bilateral corporate loans, term wholesale deposits, overdraft and trade finance facilities, covered bonds, capital securities, perpetuals and securitisations, as well as retail and commercial mortgages. Many financial instruments referencing LIBOR in the cash markets have a maturity date beyond the end of 2021.[6]

4 As the administrator of LIBOR, the IBA's aim is to ensure the integrity of the benchmark determination process and also to ensure that LIBOR will remain an effective interest rate benchmark over the long term. The IBA is understood to be fully committed to the evolution of LIBOR, and to consider that, if the need for any subjective decisions from panel banks can be reduced, this will help ensure LIBOR's continuation post-2021; and the IBA is also understood to welcome the development of alternative interest rate benchmarks to provide choice and better alignment between appropriate benchmarks and market needs, and to be willing to work with all stakeholders to help establish new reference rates.

5 Given the drawbacks to LIBOR and the risks that LIBOR may cease to be published, the authorities have decided to encourage the market to move away from LIBOR to near risk-free rate benchmarks. The other reason why the authorities need to be involved is that there is substantial market inertia in the use of LIBOR. So long as financial instruments referencing LIBOR benefit from a concentration of liquidity, the adoption of alternatives is a challenging task.[7] It is a particular challenge in the cash markets, where LIBOR is widely used for different maturity terms (eg one, three or six months).[8]

6 Although the LIBOR deadline is four years away, the market needs to start making preparations for the transition from LIBOR now: both by agreeing on successor risk-free benchmark rates in the overnight and the term market and by working out how the transition should take place to the new benchmarks in an orderly way. The transition from LIBOR will need to be coordinated globally, and communicated globally across financial markets, in view of the global use of the LIBOR benchmark.[9] Given the inter-relationship between the cash bond market and the derivatives market used as a hedge, work on both product areas needs to proceed in parallel rather than being carried out in different product areas in isolation.

The introduction of near risk-free rates

7 The authorities have two main motivations for the development of near risk-free rates (RFRs) in place of LIBOR: (i) to increase choice and improve market effectiveness, since for many transactions RFRs may be more appropriate for users than LIBOR; and (ii) to recognise that there is a structural weakness in LIBOR arising from the lack of unsecured term deposit transactions – and therefore a continued reliance on judgement.[10]

- In the first case, RFRs may be more appropriate for users than LIBOR for transactions in which the bank credit component of LIBOR is neither necessary nor appropriate. Derivatives markets in particular could be more effective if there was liquidity in alternative reference rates.[11]
- In the second case, term deposit markets which underpin LIBOR fixings are no longer a liquid source of bank funding. Even a reformed LIBOR would rely on expert judgement to supplement transactions data. More widespread use of robust transactions-based benchmarks would improve the resilience of the financial system.[12]

Secured and unsecured reference rates

8 While there is agreement between the authorities in the five main jurisdictions in which IBORs are used on the need to choose successor RFRs, in some cases the

6. In the UK, there are more than £200 billion of SME and corporate loans, around £125 billion of FRNs and £200 billion of structured debt which are referenced to sterling LIBOR. Source: Bank of England (6 July 2017). In the case of sterling FRNs, 152 bonds have a maturity of less than one year; 267 have a maturity of 2-5 years; 29 have a maturity of 6-10 years; and 71 have a maturity of over 10 years. Source: Bloomberg (2017) data derived from "SRCH function" and available at Bloomberg. (Accessed: 19 December 2017).

7. Chris Salmon, Executive Director, Markets, Bank of England: *The Bank and Benchmark Reform:* Roundtable on Sterling Risk-Free Reference Rates, 6 July 2017.

8. Of the £125 billion FRNs outstanding, 23 bonds with £8 billion outstanding reference one month LIBOR; 466 with £115 billion outstanding reference three month LIBOR; 30 bonds with £3 billion outstanding reference six month LIBOR. Source: Bloomberg: *op. cit.*

9. The Official Sector Steering Group has been tasked by the FSB to help coordinate the transition to RFRs globally.

10. Mark Carney, Governor of the Bank of England: Roundtable on Sterling Risk-Free Reference Rates, 6 July 2017.

11. In its report published in July 2014, the FSB concluded that, particularly for derivatives transactions, nearly risk-free reference rates are in many cases more suitable than reference rates that include a term bank credit risk component, such as LIBOR.

12. Chris Salmon, Executive Director, Markets, Bank of England: Roundtable on Sterling Risk-Free Reference Rates, 6 July 2017.

RFRs preferred are secured and in other cases they are unsecured, and some jurisdictions are more advanced in their choice of RFRs than others:

- *Sterling:* In the case of sterling LIBOR, the Working Group on Sterling Risk-Free Reference Rates has chosen a reformed Sterling Overnight Index Average (SONIA).[13] This is an unsecured overnight rate based on real transactions administered, calculated and published by the Bank of England. The Bank has instituted a reform process to strengthen SONIA, with a switchover planned to the reformed SONIA from 23 April 2018.[14]
- *US dollars:* The US Alternative Reference Rates Committee has recently chosen the Securities Overnight Financing Rate (SOFR), a secured overnight Treasury repo rate which is expected to be published daily by the Federal Reserve Bank of New York, beginning during the first half of 2018, as its preferred alternative to US dollar LIBOR.
- *Swiss francs:* The Swiss National Working Group has chosen the Swiss Average Rate Overnight (SARON), an overnight secured rate, administered by SIX Swiss Exchange, as its preferred RFR.
- *Japanese yen:* The Japanese Study Group on Risk-Free Rates has chosen an uncollateralised overnight call rate (ie an unsecured rate), calculated and published by the Bank of Japan.
- *Euro:* In the euro area, where the Euro Overnight Index Average (EONIA) and the Euro Interbank Offered Rate (EURIBOR) are widely used, the European Commission, ECB, ESMA and FSMA announced on 21 September 2017 that a new working group would be set up to identify and adopt an RFR which could serve as an alternative to current benchmarks. No decisions have yet been taken. The ECB also announced on 21 September that it intends to produce before 2020 a euro unsecured overnight rate based on data already available to the Eurosystem.[15]

9 Each jurisdiction has chosen the most appropriate overnight rate for its respective market, based on observable transactions so as to minimise the need to rely on expert judgement. In the UK, a key factor in the choice of SONIA was that transition of the Overnight Indexed Swap (OIS) market would not be required, while the choice of a secured RFR would have required the transition of existing SONIA-referenced OIS onto the new RFR, which would have been difficult to achieve.[16]

10 But the choice of secured rates in some jurisdictions and unsecured in others may have implications for markets across currencies. For example, a potential concern arises in the loan market, where drawings in different LIBOR currencies under the same facility are currently priced at the same margin. If different benchmarks – eg secured and unsecured – are used for different currencies, this may require different margins per currency. Publication times for different rates may also vary across currencies.

Overnight and term rates

11 In all cases, the RFR benchmarks that have been proposed are overnight rates. They have been chosen in preference to term rates because they represent the deepest and most stable markets in which the most observable transactions take place, and because the use of expert judgement can be kept to a minimum. Two main questions need to be considered in relation to term LIBOR: (i) whether current market practice for the use of term LIBOR needs to change to accommodate RFRs; and (ii) whether it is practicable to develop robust term RFRs from overnight RFRs:

- In economic terms, overnight rates and term LIBOR are not the same. Under current market practice (eg in the sterling floating rate note market), term LIBOR is a forward-looking rate, including a bank credit risk element for the term concerned, to which an agreed margin or spread is added representing the credit risk of the borrower borne by the investor. The LIBOR rate is fixed at the start rather than the end of the interest period. By contrast, the overnight RFR benchmarks proposed are not forward looking, and do not have a term credit element. A forward-looking term rate with front-end fixing provides certainty to both issuers and investors as the payments are known in advance, whereas this is not the case with backward-looking overnight rates. Floating rate notes are traded on the basis of known interest payments at the next interest payment date. If the rate is not fixed at the start of an interest period, it needs to be clear how, for example, floating rate notes can in practice be traded.

13. "The Group's decision does not create binding obligations for any market participants. Instead it is intended to act as a signal of market support for a particular benchmark (SONIA), and a platform to promote its broader adoption as an alternative to sterling LIBOR.": The Working Group on Sterling RFRs: *SONIA as the RFR and Approaches to Adoption,* June 2017.

14. Will Parry, Senior Manager, Sterling Markets Division, Bank of England: *The Development and Implementation of the Reform of SONIA,* 29 November 2017.

15. FSB: *Progress Report,* 10 October 2017.

16. Bank of England record of Roundtable on Sterling Risk-Free Reference Rates: 6 July 2017.

- In the UK, the Working Group on Sterling Risk-Free Rates considered in its June 2017 report whether a term RFR can be produced from SONIA and noted that broad adoption of SONIA will be easier to achieve if complementary interest rate products are available: for example, three-month sterling (ie short sterling) futures contracts are amongst the most actively traded instruments in the short end of the sterling interest rate curve.[17]

12 Any successor RFR to term LIBOR will need to be both robust and also acceptable to users, otherwise they may decide to continue to use term LIBOR as long as it continues to be published. An additional consideration is whether the market will accept the replacement of term LIBOR in sterling, if (say) EURIBOR continues to be used for term transactions in euro. This is another area in which international coordination is likely to be important.

Legacy financial instruments

13 In making preparations for the transition from LIBOR, one of the key concerns for market participants is to ensure continuity of contracts for outstanding legacy financial instruments referencing term LIBOR. This involves considering the fallbacks contained in the documentation for the financial instruments concerned. The European Benchmark Regulation requires that supervised entities using benchmarks should have robust written fallback plans.[18]

14 In the case of derivatives contracts, ISDA has been asked by the FSB Official Sector Steering Group to lead an initiative to improve derivatives contract robustness with a view to addressing risks that interest rate benchmarks which are currently widely used are no longer published. The objectives are: to avoid any discontinuity in valuations in the event that a fallback is triggered; to make sure that the contractual provisions are robust; and not to impede, to the extent possible, any efforts towards voluntary transition. With these objectives in mind, ISDA is drafting robust fallbacks for new derivatives contracts referencing IBORs and a future protocol to amend existing derivatives contracts referencing IBORs, which will include these fallbacks. The official sector places great importance on all industry stakeholders entering such protocols, wherever feasible.[19]

15 In the case of legacy financial instruments in the cash market, if a benchmark becomes unavailable, the ultimate fallback in loan agreements is often to an individual lender's cost of funds. In the bond market, the majority of floating rate notes ultimately fall back to a fixed rate at the last available floating rate. These fallbacks were originally intended to provide for temporary unavailability of a benchmark rather than its permanent cessation, and may not be commercially acceptable to market participants if LIBOR ceases to be available permanently.

16 There is a close relationship between the derivatives and cash markets. For example, the issuer of a bond may enter into a back-to-back swap to hedge its position. But unlike the derivatives market, neither the loan market nor the bond market has a protocol system for amendments:

- In the loan market, each individual loan agreement referencing LIBOR may need to be renegotiated and amended to refer to an alternative benchmark rate. There may also be a transfer of value in the event of a change to a different benchmark; and the parties may use the opportunity to renegotiate terms unrelated to LIBOR as well. Provisions may be included in loans to allow for a lower threshold of consent for changes to a benchmark rate (eg consent from a majority rather than all lenders). But these provisions are not always commercially acceptable.
- In the bond market, not only is there currently no protocol mechanism for the amendment of bond terms and conditions but, unlike the syndicated loan market, the ultimate beneficial owners of bonds are not easily identifiable. Amendments to bond terms and conditions ordinarily require bondholder consent via a consent-solicitation process or other liability management exercise. Amendments to interest rate provisions typically require a higher threshold of bondholder consent to be effective. Liability management exercises can be costly and time-consuming for issuers and the outcome cannot be guaranteed. If a discontinuation of LIBOR resulted in the transition to an alternative benchmark requiring legacy contracts to be amended, this would need to be done in a way which minimises the risk of significant market disruption.[20]

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17. The Working Group on Sterling Risk-Free Reference Rates: *SONIA as the RFR and Approaches to Adoption*, June 2017.

18. Under Article 28(2) of the EU Benchmark Regulation, which applied from 1 January 2018, a supervised entity (ie including a credit institution or investment firm) that "uses" a benchmark will be required to have "robust written plans" in place setting out what actions will be taken if a benchmark materially changes or ceases to be available and to reflect such plans in its "contractual relationship with clients". LIBOR is a benchmark for these purposes. See Catherine Wade: *Benchmark Reform and the Future of LIBOR: Implications for the Primary Bond Markets:* ICMA Quarterly Report for the Fourth Quarter of 2017, page 16.

19. FSB: *Reforming Major Interest Rate Benchmarks: Progress Report on Implementation of July 2014 FSB Recommendations*, 10 October 2017.

20. See Catherine Wade: *Benchmark Reform and the Future of LIBOR: Implications for the Primary Bond Markets*, ICMA Quarterly Report for the Fourth Quarter of 2017.

17 If LIBOR is sufficiently robust and continues to be available after the end of 2021, there is a separate question whether fallback provisions will be triggered or not:

- If fallback provisions are triggered, it is likely that the current bond terms and conditions will contain one of two mechanisms; screen rate determination or ISDA determination. Screen rate determination is the more widely used option, and is likely to result in the bond becoming a fixed rate note for its remaining life, because the final fallback is the last available rate.
- If fallback provisions are not triggered, interest on legacy bonds will continue to be calculated using LIBOR. Without an amendment to bond terms and conditions, the rate will continue to be determined under the existing terms and conditions.

New financial instruments

18 It will take time for new risk-free rates to be ready for use and accepted in financial markets. Some RFRs have not yet been published (eg SOFR in the US) or are undergoing reform (eg SONIA in the UK). Until an appropriate alternative rate has been identified and has gained market acceptance, it may not be clear how best to amend documentation. At the moment, there is some evidence of changes in bond terms and conditions on new issues, but not yet any consistency of approach. Some issuers have also taken the precaution of introducing additional risk factor language in new bonds to highlight any risk that may arise if LIBOR ceases to be published.

19 A priority in the market is therefore to be clear whether, and if so when, there will be an appropriate successor to term LIBOR:

- Until there is an appropriate successor rate, market participants may continue to use LIBOR for maturities beyond 2021. If so, this will increase the number of legacy transactions affected by any transition from LIBOR at a later stage.
- Alternatively, market participants may consider that there is currently too much uncertainty to issue new bonds referencing LIBOR for maturities beyond 2021. This concern may be particularly relevant for manufacturers under the MiFID II/R product governance regime.

Conclusion

20 Following the official decision to replace LIBOR with risk-free rates, this assessment has summarised some of the issues that need to be addressed in order to ensure a smooth and orderly transition.

The next phase of sterling LIBOR transition work

On 29 November 2017, the Bank of England and the FCA announced the next phase of work with market participants on LIBOR transition: *"From January 2018, the market-led Working Group on Sterling Risk-Free Rates will have an extended mandate and broader participation.*

- *The Working Group's new mandate will be to catalyse a broad-based transition to SONIA over the next four years across sterling bond, loan and derivative markets, so that SONIA is established as the primary sterling interest rate benchmark by end 2021. That reflects concerns about the sustainability of LIBOR beyond 2021, and follows a recent public consultation which confirmed strong support for SONIA as the preferred alternative to sterling LIBOR.*
- *For this next phase of work, it is clear that active engagement will be needed from participants across all relevant sectors and markets. Membership of the Working Group will therefore be broadened to include investment managers, non-financial corporates and other sterling issuers, infrastructure firms and trade associations, alongside banks and dealers. Membership will be by invitation of the Bank and FCA, with further details to be announced in coming weeks.*

A key near-term priority for the Working Group will be to make recommendations relating to the potential development of term SONIA reference rates. This work is already under way and a public consultation is planned for the first half of 2018.

François Jourdain (Chief Compliance Officer, Barclays International) will continue to Chair the Working Group. Frances Hinden (Vice President Treasury Operations, Shell International Ltd) and Simon Wilkinson (Head of LDI Funds, Legal & General Investment Management) have agreed to act as Vice Chairs.

Two new sub-groups will be formed to focus on benchmark transition issues in loan and bond markets. These will be chaired respectively by Clare Dawson (Chief Executive, LMA) and Paul Richards (Head of Market Practice and Regulatory Policy, ICMA). Other sub-groups will be created as necessary to conduct technical work to support the transition effort. Participation in these sub-groups is not limited to Working Group members.

The Working Group will be responsible for raising awareness of transition issues and seeking input from the broadest possible set of stakeholders, for example by establishing open discussion forums focused on particular sectors."

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