The Association of Corporate Treasurers

Comments in response to
SONIA as the RFR and approaches to adoption,
The Working Group on Sterling Risk-Free Reference Rates
June 2017

September 2017

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. It is established by Royal Charter in the public interest. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details and a link to our approach regarding policy submissions can also be found at the back of these comments.

We canvas the opinion of our members through seminars and conferences, monthly e-newsletters, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

The ACT welcomes the opportunity to comment on this matter.

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General

Corporates need a stable and reliable interest rate benchmark for not only business and financial contracts but also to forecast, manage and account for many business activities. At present, LIBOR, as the world's most widely used interest rate benchmark, is conventionally used extensively across the corporate environment.

It is important to note that corporates not only use LIBOR benchmarks in financial derivatives for interest rate hedging and fixed/floating rate adjustment, they also use LIBOR extensively in pricing underlying instruments, particularly loans – both externally and, importantly, intra-group.

The responses below focus on the development of the use of a risk free rate (RFR) benchmark in the derivatives market, but we observe that the recent announcement by the FCA that they will not continue to support LIBOR beyond the end of 2021 has resulted in a pressing need to expand the work to identify an alternative benchmark beyond the derivatives markets to identify and resolve the issues that such a change to the fundamental operation of the financial markets will cause.

In response to this, the ACT has, where appropriate, expanded responses to the questions below, to address some of the issues identified as a result of the recent FCA announcement.

Question 1: Based on the Group's assessment of the candidates against the selection criteria, do you agree with the choice of SONIA as the preferred RFR? Do you have any additional views on this assessment?

From a corporate perspective, the pre-requisites for a 'successful' benchmark are that it is stable (fundamentally not more volatile than the market it represents), reliable (its calculation is transparent), relevant (meets the needs of the user – e.g. for risk management) and readily available (widely and freely accessible by any interested party on a timely basis).

With specific reference to SONIA, the lack of same-day availability of the rate will require a work around to be developed by the market.
Additionally, the ability to build term extension will be essential as 1 month, 3 month and 6 month LIBOR fixings are widely referenced in commercial (and debt) contracts.

There needs to be a coordinated approach to the resolution of these challenges as a bank by bank or product by product solution will not be realistic.

Question 2: Do you have any views on the preferred design and use of a SONIA futures contract?

No comment on the use of SONIA in futures contracts.

Question 3: Do you have any views on the extension of maximum maturities for cleared sterling OIS products?

Beyond the observation made in the white paper that swaps clearing will need to be extended out to 50 years, which we would strongly support, we have no further comment.

Question 4: Are there any other issues related to the development of interest rate derivatives products referencing SONIA, which the Group need to consider?

In addition to the issues that are referenced in the June 2017 paper,

- Operational risks: Corporates need to have sufficient time to calculate and agree the settlement amount at each reset date for interest rate derivatives. For a sizeable portfolio, this may take a few days and hence the development of a benchmark where the rate is known in advance of the payment date is needed. This requires a benchmark with a maturity tenor. Additionally, not knowing cash flows in advance will result in liquidity risk, with consequential settlement risk if settlement amounts cannot be calculated and funded in a timely manner. This could result in market disruption or even counterparty failure.
- If legacy transactions need to be 'repapered', there may be disputes with counterparties over the financial implications and there are resultant hedge accounting (IFRS) and EMIR reporting (and margining) implications as grandfathering arrangements will be lost.
- When developing interest rate derivative products, consideration needs to be given to how these interact with other instruments. For example, end users will use interest rate swaps extensively to hedge interest rate exposure arising on underlying debt (or cash) products. Any market reform should be designed to enable end users to manage both corporate funding and financial risk effectively.

Question 5:
a) What do you think is the appropriate scope of SONIA adoption across the broader financing instruments?

The use of SONIA as a benchmark rate for derivatives cannot be considered in isolation. Corporates do not generally trade the benchmark or use derivative instruments to speculate. They use derivatives to hedge financial risks and choose, where possible, derivatives that mirror the benchmark of the underlying instrument (e.g. a fixed vs LIBOR swap to hedge floating rate debt that references LIBOR) so as not to result in basis risk. Hence for corporates to want to use a derivative that references SONIA in many cases the underlying instruments must also reference SONIA.

b) What issues might arise in relation to referencing SONIA in these instruments?

In addition to the points made previously about the backward looking and lack of term structure in the SONIA RFR, the following considerations are relevant:

- Legacy contracts: - in some markets, legacy contracts may extend out to 30 + years. The complexity /cost of resolving issues with legacy contracts will be a major factor whether the adoption of SONIA can be fairly introduced.

- Comparability of benchmark rates: - Multinationals may raise finance either in local currency and/or where cost of funds is lowest. There will need to be a mechanism to compare between different benchmarks (potentially one based on unsecured and another based on collateralised transactions) when deciding which currency to raise and the ability to transact cross currency swaps which reference appropriate benchmarks.

- Accounting Considerations: – hedge accounting implications, such as re-designation of hedges or a requirement to retest hedge effectiveness calculations, may arise if existing contracts have to be 're-papered'. This could result in a material impact to the financial statements.

- Regulatory implications: – for example the issue of re-papering may trigger EMIR reporting requirements.

c) Are there other instrument types for which SONIA could be adopted as the primary reference rate, which the Group should consider?

In order to be a successful replacement for LIBOR, SONIA would need to replace LIBOR in all markets that currently reference LIBOR.

The LIBOR benchmark is not purely used in financial instruments. For example, LIBOR is used as a discount factor or reference rate in commercial contracts (e.g. for late payment or cost increases in long dated contracts).

Question 6:
a) Recognising the trade-offs between a backward- and forward-looking RFR, do you believe that a term RFR is necessary?

Given the cost and complexity for end users in trying to adopt a backward looking RFR, we would recommend that a forward-looking rate is highly desirable. As outlined in our response to question 4 above, we believe tenors are vital.

b) Are there particular markets which could struggle to adapt to using overnight fixings?

End users (other than the largest, most sophisticated) need notice of the amounts under interest fixings payable so that they can both calculate and access liquidity in order to pay as the interest falls due.

c) Do you have a preference for the potential construction of a forward-looking term RFR?

No comment.

d) Would multiple term options (e.g. 1-month, 3-month, and 6-month) be necessary, or could a single term fixing option be acceptable?

Research would need to be conducted to identify whether it would be possible to restrict the number of term fixings.

Current market practice is such that for example, if a corporate draws down under its Revolving Credit Facility, for three months, this drawing will reference 3 month LIBOR; if the drawing is for one month, they will reference one month LIBOR. The flexibility as to the length of drawing is fundamental to efficient financial management in the real economy.

Question 7: Do you agree that there are merits in exploring the conversion of legacy portfolios – across both interest rate derivatives and other instruments – to reference the RFR?

We do not believe that it will be possible to not convert legacy contracts to a new benchmark unless LIBOR continues to be published. In Andrew Bailey's speech of 27 July 2017, he is suggesting that LIBOR will no longer exist post 2021. If this is the case a replacement will need to be identified and implemented across all relevant markets.

However, we would caution that there will be considerable cost (both financial and in time) to the conversion of legacy contracts and some market participants might seek to take financial advantage of any change.

Question 8: What other issues might arise as part of an effort to convert legacy LIBOR portfolios to reference SONIA?

In addition to the issues raised in the white paper, we have the following observations:

- Two benchmarks: - There is a risk that LIBOR continues to exist and some banks continue to use LIBOR and others switch to SONIA. This will complicate, or even frustrate, the following
    - Portfolio hedging: - Corporates often hedge on a portfolio basis and across various financial counterparties and if different instruments moved to different benchmarks at different times, this would become ineffective.
    - Cash settlement pricing: - Swap contracts may contain a clause setting out the Cash Settlement price (to facilitate closing out a swap early). The calculation methodology may not be defined in the documentation with a resultant inconsistency between banks using SONIA or LIBOR to calculate the discount factor.
    - Fallback language: - considerable reliance is currently being placed on the ability of the market to adopt fallback language, however this will not be possible in the event that LIBOR continues to exist in some form.

- Timing of transition: - in order to streamline the conversion of financial contracts, it needs to be understood whether a 'Big Bang' approach, and/or some sort of fixed rate pegging (rather as happened with the transition to the euro) would be preferable. Any approach needs to be clear, straightforward and not subject to misinterpretation.

- Transition Cost: – in addition to the cost in systems development, ‘repapering’ etc., there may be a transition cost as the reference benchmark is switched from LIBOR to SONIA. It is highly likely that there will be one counterparty in each contract that will incur some sort of revaluation cost. A one basis point change on a multi-billion-pound contract can have a significant negative impact and may lead to liquidity risk in satisfying a conversion payment.

- Broader economic implications of switching benchmarks. This will include resource requirements, systems change and legal costs. The additional cost of making changes to systems for example will direct resources that could otherwise be used to invest in economic expansion.

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The Association of Corporate Treasurers

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Our 4,900 members work in companies of all sizes through industry, commerce and professional service firms. We have 2,300 active students. Members and students work in 84 countries and are employed by 88% of the FTSE100 companies.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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