LIBOR Transition - Frequently Asked Questions

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This document is a summary of the questions submitted during or following the webinar on LIBOR transition recorded on 6 December 2018 and which can be accessed at: https://www.treasurers.org/webinars/LIBORtransition

In addition to the responses below, '**What you need to know about LIBOR transition**' produced by the Working Group on Sterling Risk-Free Reference Rates; The Treasurer's Checklist and materials on https://www.treasurers.org/liborreform are helpful resources.

1. Selection of Risk Free Rates by currency

> What does SONIA stand for?
> Is LIBOR cessation only for GBP?
> Has a USD LIBOR alternative been selected yet?

This announcement impacts all 5 LIBOR currencies: USD, GBP, JPY, EUR, CHF. Other countries are also considering changing their term benchmarks for similar reasons (e.g. BBSW in Australia).

The alternative RFR (near Risk Free Rates) benchmarks that have been identified are:

US:	SOFR	Secured Overnight Funding Rate
EURO:	ESTER	European Short-Term Euro Rate
Japan:	TONAR	Tokyo Overnight Average Rate
Switzerland:	SARON	Swiss Average Rate Overnight
UK:	SONIA	Sterling Overnight Index Average

> When is the SOFR reference rate expected to be ready?
> You mentioned H2-19 for the UK, what is the expected timeframe for the US SOFR benchmark?

The ARRC (US working group)'s timetable and key milestones are here: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Progress-Timeline-Oct-30.pdf
More details and historic data are available at https://apps.newyorkfed.org/markets/autorates/sofr.

> What does ESTER relate to? i.e. what currencies would this apply to?

It relates to EUR denominated transactions.
The EU area working group has recommended ESTER (Euro Short Term Rate) as the euro risk-free rate to replace EONIA. This is not expected to be quoted until October 2019. In the meantime, EURIBOR is also being revised to become a compliant benchmark. See https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html for details.

>There is mention of the Bank of England....Does the ECB not have a role here?

Each LIBOR jurisdiction has its own working group looking at selecting a new rate, transition issues etc. They are typically 'market-led' but convened/supported by the national bank and/or the regulator. So, the GBP working group is supported by the BoE, the USD one is supported by the Fed, the Euro one is indeed supported by the ECB.

2. Market developments

> Whilst depth/liquidity is building, will there not be potential for significant volatility in the rate?

SONIA has significantly more liquidity now than any of the existing LIBOR term rates, and when looked at on a quarterly compounded basis is less volatile that 3m LIBOR. Liquidity in SOFR is still building but this is not a massive concern.

> Are banks already lending using the new reference rates?

The short answer is no to loans but yes for bonds and derivatives.
There is a rapidly growing futures market in SONIA and SOFR, and there is a well-established market in OIS (overnight index swaps) both spot and forward starting which reference SONIA. There have been some well-publicised bond issuances based on both SONIA and SOFR but no publicly known bank lending that we are aware of.

> How can people avoid writing longer term LIBOR referencing business if a stable alternative doesn't yet exist?
>Preparing for RCF renewal beyond 2021...what should we look out for?

The markets are not yet in a position to include a SONIA (or SOFR) based interest rate in an RCF (in addition, market participants do not yet have the systems and infrastructure in place to lend/borrow on that basis) and so, longer-term LIBOR referencing contracts will continue to be issued for the foreseeable future.

However, it is important to enter into these arrangements knowing that the interest rate benchmark is almost certainly going to change. That means including language in any loan or bond documentation that acknowledges the fact and has a mechanism for making changes without having to renegotiate the entire agreement.

Some of the documentation risks include:

(i) if you are using hedge accounting and you make a ‘substantial’ change, your hedges may become ineffective;
(ii) you end up needing every bank in your syndicate to agree to any changes to a loan agreement; and
(iii) because you now need a new agreement, everything else that you had previously agreed becomes open for negotiation again.

See the links to other materials above that expand on considerations when negotiating in both the loan and bond markets as well as offering alternate language for loan agreements.

> Will trades (e.g. swaps) that reference SONIA have to be set in arrears, or do you believe term rates will be developed in time?

There is a lot of market commentary that term rates derived from Risk Free Rates should not be widely used for derivatives; in general, they should be limited to ‘cash’ market e.g. loans and bonds and associated hedges.

For the cash market, the BoE working group and the US working group (the ARCC) have acknowledged a need for term rates in some segments of the market.

> In regard to derivatives, is there likely to be any change in the issuance time of 9:30 or is the market looking at a standard to facilitate the operational processes behind SONIA linked payment?

It would be for the administrator of SONIA (Bank of England) to determine any changes to publication times.
That said there is quite an administrative process for creation of SONIA with reports submitted on a daily basis by banks after 6pm, followed by a series of checks made by the Bank which can involve remediation/clarification of transactions with reporting banks. With this in mind it may not be operationally possible under the existing process for a significantly earlier publication.

One challenge that has been identified is the potential for various jurisdictions to publish their domestic RFR at different times, complicating cross currency settlement and multi-currency loans drawdowns.

> Historical secured debt facilities often include a requirement to hedge the floating rate exposure, when the reference rate changes. Is it possible that the loan and derivative contract reference differing reference rates?

There is certainly a risk that this could happen, which may lead to challenges with hedge accounting or covenants. There isn't a simple answer that will work for everyone, it depends on what the floating rate exposure is – for example it's possible now to enter into a basis swap (changing the floating exposure from LIBOR to SONIA) and then into an OIS changing the exposure from SONIA to fixed but that may not be the right answer for any particular transaction.

3. **Market operations**

> Are you physically settling interest every day?

Generally, this does not happen, interest is settled at the end of the contract 9or on rollover dates) as present.

> What does a 5 day SONIA lag achieve over e.g. a 2 day lag?

Nothing specific. It simply gives people longer to sort out their systems, ensure they have the right funds being paid to the right account on the right day with the right approvals from an account with the right money in the right currency.

> What is the 5 day lag in the Lloyds transaction?

The 5 day lag is the 5 day look-back period customary with recent SONIA issuances; essentially the daily interest rate is set by referencing the rate five days previously. Daily interest rates are then compounded over the interest period and the final interest rate calculated and settled at the end.

> Would value transfer occur if SONIA simply became the replacement reference rate to LIBOR?

There is a spread between SONIA and 3m LIBOR (the 'basis spread') as a consequence of both the credit risk inherent in LIBOR and the term difference. Therefore, a direct conversion of contracts from 'SONIA' to 'LIBOR' is highly unlikely exactly because of this difference – there would be significant value transfer.
This basis spread varies over time – a good part of the recent ISDA consultation on fallbacks discussed alternate solutions to derive a 'fair' spread to use when converting LIBOR-related contracts to SONIA ones.

The issue for existing long-term transactions is how to convert – many existing bonds have 'LIBOR replacement' language that includes, for example, perhaps engaging an 'independent financial advisor' to consider on the best way to convert without value transfer.

> How was the spread between SONIA and 3m LIBOR calculated on the Lloyds Covered Bond?

SONIA is a traded benchmark in the UK and as such, Libor SONIA basis swaps are in existence. As such it is possible to derive a sensible spread to SONIA using secondary bond information and basis swap rates.

> Which TMS systems are coming forward with proactive solution to this?
Most of the major TMS will already have functionality that works 'in theory' but we are not aware of any firms actively promoting system solutions or implementation projects.