A future beyond LIBOR

LIBOR – Looking back

In 2012, following widespread allegations of LIBOR manipulation and numerous fines imposed on several international banks, the UK Government conducted the **Wheatley Review (2012)**, which:

- Recommended reform, rather than replacement, of LIBOR;
- Called for strict processes to verify submissions with transaction data;
- Suggested that market participants should play a significant role in LIBOR production and oversight.

In early 2014, the Intercontinental Exchange (ICE) took over the administration of LIBOR, prompting a **Review of the Implementation of IOSCO's Principles for Financial Benchmarks (2014)**, which found that ICE LIBOR was more "closely aligned" to IOSCO Principles than BBA LIBOR, but also:

- Questioned whether LIBOR provided an accurate and reliable representation of the economic realities it sought to measure;
- Criticised lack of any transition plans for cessation/discontinuation (but noted ICE's successful discontinuation of several currencies and tenors in absence of such plans);
- Accepted that, since LIBOR had only recently been taken over by ICE, time would be needed to implement the changes required to attain total compliance.

The FSB's 'multi-rate approach'

The FSB released a report on **Reforming Major Interest Rate Benchmarks (2014)** suggesting a 'multi-rate' approach to reforming interest rate benchmarks across currencies:

1) **Strengthen existing IBORs**
   - Anchor in transactions
   - Fully implement IOSCO principles
2) **Develop alternative nearly risk-free reference rates**
   - As robust alternatives for IBORs
   - Which are better suited for use in many applications

The Future of LIBOR- 27 July 2017- Andrew Bailey speech

Limitations to LIBOR reform

– Significant improvements have been made to LIBOR since 2013.
– But the absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets.

The way forward

– Panel bank support to sustain LIBOR until end-2021 will enable a transition that can be planned and executed smoothly.
– Work must begin in earnest on planning the transition to alternative reference rates that are based firmly on transactions.
– **“Our intention is that, at the end of this period, it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR.”**

IBOR alternatives for the LIBOR currencies - ‘Risk Free Rates’

USD
- Secured Overnight Funding Rate (SOFR)
- New UST repo rate to be published by FRBNY

CHF
- Swiss Average Overnight Rate (SARON)
- Developed by the SNB in collaboration with SIX Swiss Exchange
- Replaced TOIS benchmark upon termination December 2017

JPY
- Tokyo Overnight Average Rate (TONAR)
- Existing uncollateralised overnight call rate published by the BOJ

EUR
- ECB to develop euro unsecured overnight rate
- Private sector working group to select RFR for euro area

GBP
- Sterling Overnight Index Average (SONIA)
- Reform of SONIA to be completed by 23rd April 2018

History of LIBOR in syndicated loans

- Origins of LIBOR believed to be in 1969 when a $80mn syndicated loan was made to the Shah of Iran based on the reported funding costs of a set of reference banks
- This type of lending became successful because:
  - London had become a hub for dollar deposits outside the US
  - Deployment of “Eurodollars” enabled groups of lenders to lend large amounts according to individual capacities, to those wanting to borrow dollars (outside the US)
  - Equated to a rate that all parties were happy to use
  - In a period of high interest rates and high inflation, banks were wary of committing to lending at a fixed rate for long periods. A solution was therefore to charge borrowers an interest rate, recalculated every few months and funded by rolling deposits
  - The formula at the time was simple: syndicate banks reported their funding costs prior to a loan-rollover date
  - LIBOR then became a proxy for bank borrowing costs across the financial markets

Utilisation – Agent's Role

Borrower delivers utilisation request to Agent

↓

Agent notifies Lenders of amount of the loan

↓

Agent calculates LIBOR/EURIBOR

↓

Agent notifies Borrower and Lenders of LIBOR/EURIBOR

↓

Agent receives funds from Lenders on utilisation date

↓

Agent pays funds to Borrower on utilisation date

NB: this is a manual process!

1 institution = 170,000 payments processed per quarter across the UK and the US

Steps 3 and 4 are repeated on every interest payment date until loan is repaid

Implications for borrowers and lenders

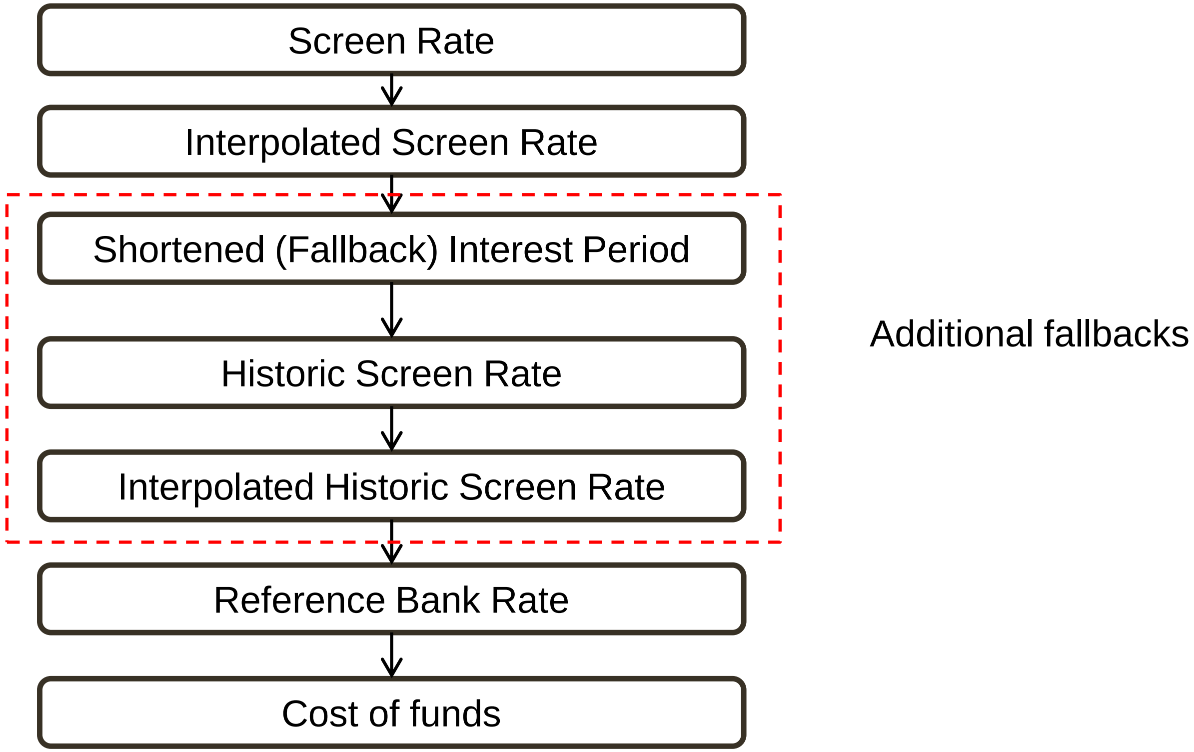
- Individual loans cannot be amended unilaterally
- Loans are a “relationship” product, not easy to automate
- Borrowers expect direct human interaction (via relationship manager or agent)
- Borrowers are not always sophisticated e.g. in terms of use of derivatives and more complex structures
- Agents deal with large number of queries (both borrower side and lender side)
- Flexibility and optionality is key for the product to work e.g. multicurrency facilities

Calculating interest: LIBOR and the LMA documents

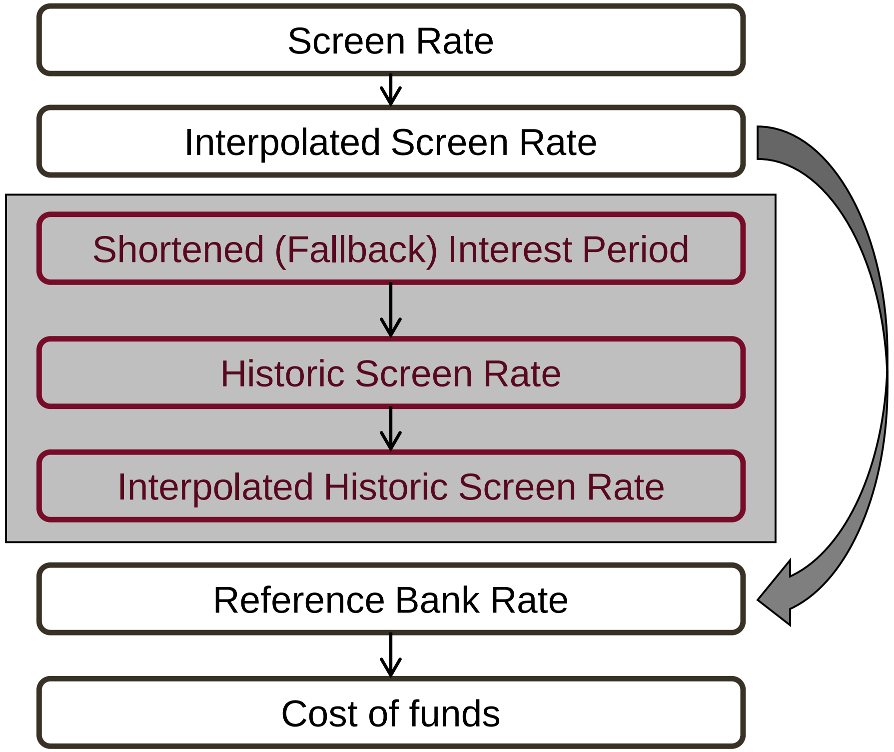
- Changes were made to the interest rate fallback provisions in LMA documentation in November 2014 following reforms to LIBOR

- Disappearance of LIBOR for “less common” currencies and tenors caused unexpected difficulties

Post-November 2014 fallback waterfall: Option 1



Post-November 2014 fallback waterfall: Option 2



Use of fallbacks

- Not designed to be used long-term, or where LIBOR has been replaced by a different rate with a different methodology for calculation
- Difficult to get Reference Banks to quote; may not quote if LIBOR ceases to exist and the LMA documentation does not compel them to do so
- Ultimate fallback would be to cost of funds, which as we saw from 2014 is not administratively workable long-term
- So a longer-term solution was included:
  - Majority lender and borrower consent to move to a new benchmark

Replacement of Screen Rate

- Optional provision: Majority Lender (and Obligor) consent required for replacing a Screen Rate which is not available for a currency
  - "*any amendment or waiver which relates to providing for another benchmark rate to apply in relation to that currency in place of that Screen Rate…*"

- Commercial acceptability?

Use of alternative benchmarks – key issues

– Need for a term rate
  - Overnight rate v term rate
  - Backward v forward-looking
  - Certainty of funding costs

– Operational issues
  - Loan systems
  - Multiple v single benchmark(s)

Use of alternative benchmarks – key issues

- No clear alternative as yet
  - Focus has been on the derivatives market rather than cash markets (note inter-relationship of products)
  - Some RFRs not yet in existence
  - How to document deals today?
  - Updating of templates absent alternative

- Different rates across different jurisdictions
  - Coordination between jurisdictions and product areas (common concerns)
  - Secured v unsecured
  - Pricing / value shift
  - Publication times

Use of alternative benchmarks – key issues

- Legacy contracts
  - Suitability of existing fallbacks long-term
  - Amendment process (no protocol system, cf ISDA)
  - Deals documented today

- Market led solution
  - Competition concerns
  - Regulator support

LIBOR currencies moving forward

Currency	Working Group	Key sub-groups established	Timescale
GBP	Bank of England Working Group on Sterling Risk-Free Rates	“Term-rate”, “Loan market transition” & “Bond market transition”	Reform of SONIA to be completed by 23 April 2018 (*term-rate consultation H1 2018*)
USD	Alternative Reference Rates Committee	“Market Structures”, “Regulatory Issues”, “Term Rate” & “Legal”	Production to begin H2 2018 (*see next slide*)
EUR	European Central Bank Working Group on Euro Risk-Free Rates	-	New euro RFR to be finalised before 2020
CHF	Swiss National Working Group	“Loan and deposit market” & “Derivatives and capital market”	Switched from TOIS to SARON on 29 December 2017
JPY	Study Group of Market Participants / Working Group on Use of the Risk-Free Rate	-	-

Next steps for SOFR transition

Q1 2018 – Announcement of exact production date for SOFR

H2 2018 – Federal Reserve Bank of New York (FRBNY) to begin publishing SOFR

Q4 2018 to Q2 2021 – Transition by ARRC members to SOFR in derivatives markets with aim of building up liquidity to produce a SOFR term reference rate for cash markets

By end of 2021 – Creation of a term reference rate based on SOFR-derivatives markets once liquidity is sufficient to produce a robust rate

Next phase of work on sterling LIBOR transition

Mandate	Catalyse a broad-based transition to SONIA by end-2021
Membership	RFR WG broadened to include: • Investment managers; • Non-financial corporates and other sterling issuers; • Infrastructure firms; • Trade associations; and • Banks and broker deals
Key sub-groups	• Term SONIA reference rates • Loan market transition • Bond market transition • Other issues, as appropriate
Stakeholder forums	Open discussion forums focused on particular sectors to raise awareness and provide input to RFR WG.

Term SONIA reference rates

Chair and membership

• Sub-group of RFR WG chaired by Nick Saggers of BAML and including a broad cross-section of market participants. The LMA and ACT are actively involved in this work.

• Plan is to publish consultation in first half of 2018.

Key objectives and deliverables

• Assess relevant potential use cases.

• Review potential data inputs and calculation methodologies (e.g. 1, 3 and 6 month rates derived from regulated OIS prices).

• Propose measures to limit systemic reliance on these indices.

• Agree design criteria for potential administrators and data providers.

Transition issues in syndicated loan markets- sterling

Chair and membership

• New sub-group of the RFR WG to be chaired by Clare Dawson (Chief Executive, LMA) and include a broad cross-section of loan market participants.

Key objectives and deliverables

• Develop documentation which could allow discretionary transition to new benchmark.
• Develop template documentation for SONIA referencing loan facilities.
• Develop contingency plans for legacy LIBOR loans.
• Promote the use of RFRs in syndicated loan facilities.

Next steps

- The reconstituted RFR WG will focus on:
  - Catalysing liquidity in SONIA listed and OTC derivatives
  - Potential development of term SONIA reference rates
  - Adoption of SONIA in sterling bond and loan markets
  - International coordination of RFR adoption
- ISDA working groups remain focused on establishing robust contingency rates for derivatives contracts.
- During the next phase of work, engagement from all types of market participants will be required.
- Loan market participants can engage via the LMA or by contacting RFR.Secretariat@bankofengland.gsi.gov.uk