Quarterly Quiz
Quarter One 2015

Evolution of LIBOR and the impact on borrowers

Following well-documented problems with the LIBOR benchmark rate, there have been many changes, not least that the British Bankers Association (BBA) no longer administers the benchmark. That task is now undertaken by ICE Benchmark Administration (IBA). The whole process of LIBOR rate publication – rate contribution, calculation of the relevant truncated averages, publication of the rate and its administration became a regulated activity in the UK on April 2nd 2013, following the Regulated Activities Order made under the Financial Services and Markets Act 2000 and under the Financial Conduct Authority's Handbook (MAR 8).

Some changes can affect loan agreements that specify the use of LIBOR as a benchmark rate and accordingly the Loan Market Association (LMA) updated its recommended facility documentation on 12 November 2014. On November 18 2014, the ACT published a Benchmarks Supplement to The ACT Borrower's Guide to the LMA Loan Documentation for Investment Grade Borrowers that had itself otherwise been fully updated in April 2013. The Supplement summarises the key changes in the LMA documentation and the implications for borrowers.

One of the changes covered is the situation when a particular screen rate is unavailable for LIBOR. Under these circumstances, Investment Grade Agreements have always provided for a Reference Bank rate to be used in substitution for LIBOR. About three Reference Banks are appointed by the Agent in consultation with the Borrower; they provide quotes and the average of these is the Reference Bank rate.

The problem that has arisen under the revised LIBOR determination procedures is that some lenders are now unwilling to be considered as Reference Banks; therefore the Reference Bank rate may not be a viable substitute when the screen rate is unavailable.

Question 1

Which of the following is NOT a reason given for some lenders not wishing to be considered as Reference Banks?

(a) There is a potential conflict with banks' obligation to keep their benchmark submission confidential

(b) Under conditions of market disruption, when the screen rate is unavailable, banks are unwilling to disclose the rates they are having to quote in order to fund themselves

(c) Under conditions of market disruption, when the screen rate is unavailable, banks may not be in a position to quote at all.

(d) The Reference Bank role may involve unlimited responsibility to other parties to the facility, particularly with respect to the limited exposure accepted by the Agent.

(e) Don't know

Answer

The right answer is (b). Under conditions of market disruption, when the screen rate is unavailable, banks are unwilling to disclose the market rates they are having to quote in order to fund themselves.

This is not one of the reasons given, although it may in fact be an underlying reason for reluctance.

In the LMA standard wording, after a waterfall of interpolations, etc. for a missing LIBOR rate, the fallback position is that banks' cost of funds should be the replacement for the benchmark rate.

The Supplement, like the Guide itself, is produced by the ACT and Slaughter and May and covers the other LMA interest rate benchmark changes as well as the waterfall of alternatives.

The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers: Benchmarks Supplement [http://www.treasurers.org/node/10683.](http://www.treasurers.org/node/10683)

EMIR: compulsory changes

In September 2014 the European Securities and Markets Authority (ESMA) requested its trade repositories to add data validation requirements to the trade reporting submissions (reporting of OTC derivative trades) that they receive from non-financial companies. This requirement means that some companies may have had to make changes to their IT systems in order to comply. Such changes normally take a significant time to be sure that adequate testing has been undertaken to be confident of success.

As a result of ESMA's request, the trade repositories required compulsory amendments to their reporting files to be made before their deadline of December 1st 2014.

Question 2

Of the 80 fields in total that comprise the EMIR submission, how many required modification to comply with the ESMA/trade repository's requirement?

(a) 10
(b) 20
(c) 30
(d) 40
(e) Don't know

Answer

The right answer is (c) 30

Given the work that has gone into the preparation for EMIR compliance, the EACT has argued that to give less than two months' notice of such changes is inadequate.

The EACT's letter to ESMA highlighting the difficulties face by European companies.

http://www.treasurers.org/node/10638

Evolution of LIBOR

In October 2014, ICE Benchmark Administration (IBA) put forward proposals for the further evolution of ICE LIBOR. These proposals have been responded to by ACT in January 2015.
For the most part, ACT was supportive of the proposals that help ensure that LIBOR can always be satisfactorily determined. However there were a small number of points on which the ACT had some concerns.

Question 3
Which of the following proposals has the ACT expressed the most concern?

(a) The idea of a waterfall methodology of sequential bases for LIBOR determination
(b) The proposal that submitters should reference wholesale funding deposits plus commercial paper and primary issue CDs in their rate submission
(c) The proposal that "all wholesale and professional entities" should be regarded as eligible counterparties
(d) Rates should be taken from a bank's principal funding centre, wherever located, rather than its principal funding centre offshore from the currency-issuing jurisdiction.
(e) Don't know

Answer
The right answer is (d) Rates should be taken from a bank's principal funding centre, wherever located, rather than its principal funding centre offshore from the currency-issuing jurisdiction.

The idea of a waterfall methodology was supported in the ACT's response: "We are, then, supportive that "a waterfall methodology should be followed, normally using pre-defined parameters specified by IBA from time to time"" even though there was recognition that judgement and a flexible approach may be needed in times of stressed markets.
The proposal to reference CP and CDs as well as wholesale funding deposits was broadly supported although again, the need for judgement was evident.
Regarding the proposal that counterparties be expanded, the ACT response said that the proposal that "all wholesale and professional entities should be regarded as eligible counterparty types" certainly makes sense – but it is necessary to recognise "that ... judgement is required".

However, regarding the use of the bank's principal funding centre, as opposed to its principal offshore funding centre for the currency (outside the currency-issuing jurisdiction), the ACT response was "We are very concerned by the discussion under 5.7.3, Location". LIBOR has been an offshore, euro-currency, rate not a domestic rate (with the possible exception of sterling). The ACT's argument is that, whilst under normal conditions the proposal may make little difference, under market stress the change could be major and shift material value between parties to contracts.

The ICE proposals: https://www.theice.com/publicdocs/ICE_LIBOR_Position_Paper.pdf
The ACT's Response: http://www.treasurers.org/node/10783

Money Market Fund (MMF) Regulation (MMFR)

Regulation of MMFs has proceeded slowly for the last two years. Regulations were proposed by the European Commission (EC) in 2013. However, the European Parliament (EP) was unable to agree its position before a new Parliament was elected and new Commissioners appointed. Work continues under the new Commission and the new Economic and Monetary Affairs Committee of the Parliament (ECON) has agreed a revised proposal that is expected to be approved by the Parliament at the end of April. Then the Council of Ministers (CoM) needs to agree its version of the regulation. Then the "trialogue" between the EC, EP and CoM can start.

The original proposal included:

- all Constant Net Asset Value (CNAV) funds to be required to hold a 3% cash buffer,
- limits on amount of business with a single counterparty,
- binding rules on the types of assets that MMFs can invest in and
- a ban on soliciting external credit ratings.

Question 4

Which of the following is included in ECON's revised proposal on the regulation of MMFs to be considered by the Parliament plenary?

(a) To increase the requirement for a cash buffer from 3% to 5% for CNAV funds
(b) CNAV funds that are not restricted to investing in public debt instruments (government and related debt) would be open to investment by public authorities and related bodies, charities and not-for-profit organisations but not for corporate investment
(c) Rules on types of assets in which MMFs may invest would be removed
(d) Abandonment of MMF regulation on the grounds of complexity
(e) Don't know

Answer

The right answer is (b).

"Retail" CNAV funds would be open to investment by public authorities and not-for-profit organisations but not corporates. "Public Debt" CNAV funds that would not restricted on the type of investors would have to invest 99.5% of assets in public debt. There would also be a new "Low Volatility Net Asset Value" (LVNAV) category of MMFs that may display a CNAV but would be restricted to very short-term investments and they would be phased out under a 5-year "sunset" clause.

ECON's draft requires both CNAV types and LVNAVs to apply "liquidity fees" and "redemption gates" to help stem sudden outflows under certain circumstances. The also includes a deletion of the Commission's proposal for a 3% capital buffer for CNAV funds.

The issues here for treasurers include concern that MMFs continue to be available and viable as diversified investment products, the consequences of a ban on credit ratings of MMFs, and the need to explain Variable Net Asset Value (VNAV) funds to their Board's investment committees. Treasurers *that need to consider US as well as European funds would need to note potential complications from the European's approach to regulating MMFs inconsistentcy with the US approach.*

The EP's press release following the ECON vote is at http://www.europarl.europa.eu/pdfs/news/expert/infopress/20150224IPR25114/20150224IPR25114_en.pdf. EACT's (approximately) monthly reports on the state of European legislation on treasury-related issues are at [http://www.treasurers.org/node/9894.](http://www.treasurers.org/node/9894)

SEPA 2.0

1st August 2014 passed quietly, after concerns about the SEPA deadline proved to be unfounded. There was no sudden catastrophe in terms of rejected payments. Overall the transition appears to have gone smoothly although not all countries have made the transition yet. In Italy and Spain the tax authorities were unwilling to sanction a change to a central pan-European bank account. These countries are due to follow later.

This initial phase of SEPA adoption has been achieved but cannot yet be regarded as a success because the hoped-for gains have not materialised. Reasons for this include the problems with software and systems where there have been many different versions of the XML mandated for SEPA. In addition, legacy national systems are still in operation. The deadline for full compliance in the euro area is February 2016.

SEPA 2.0 is the unofficial term for this full compliance, when differing XML variations must end, conversions services stop and the national schemes, as in Germany, must be switched off. It also refers to the achievement of SEPA's promised benefits; cheaper payments and more convenient e-commerce payment platforms. The hope is that these benefits will be achieved as SEPA beds in, in conjunction with the Payment Services Directive II.

Question 5

At present SEPA is required for euro payments in the euro area. Non-euro countries, Denmark and the UK are required to join SEPA by which of the following dates?

(a) August last year!
(b) November 2015
(c) February 2016
(d) October 2016
(e) Don't know

Answer

The right answer is (d) October 2016

Jonathan Williams, Director at Experian has said that "It is not clear that all non-euro countries are ready for IBAN-only payments, however, so some oversight of this later migration to SEPA is advisable."

The Treasurer, December 2014/ January 2015 SEPA revisited by Neil Ainger http://www.treasurers.org/node/10720

The size of the UK banking system

The UK banking system was around 100% of UK GDP in 1975 and 450% of GDP in 2014 according to a study by the Bank of England: *Why is the UK banking system so big and is that a problem?* This study projects the future size of the banking system relative to GDP and tries to answer the question of whether a large banking system is a problem.

While the UK has the largest banking system out of the US, Japan and the 10 largest EU countries, they find that it is resilience that matters rather than size *per se*. They quote evidence from the recent global crisis that while larger banking systems may impose higher direct fiscal costs on governments in crises, the size of the banking system was not a good predictor of the crisis.

Question 6

Using 'plausible assumptions' the Bank of England study found that the size of the UK banking system in 2050 could rise to be which of the following?

(a) 600% of GDP
(b) 750% of GDP
(c) 850% of GDP
(d) 950% of GDP
(e) Don't know

Answer

The right answer is (d) 950% of GDP

In money terms this would represent a rise from the current GBP 5 trillion to GBP 60 trillion. The authors argue that as the size of the global financial sector increases in size the share of the UK is likely to rise commensurately.

The Treasurer Dec2014 (web exclusive): UK banking system could reach 950% of GDP by 2050
http://www.treasurers.org/node/10759

Bank of England article : Why is the UK banking system so big and is that a problem?
http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q402.pdf