

Stand out for the right reasons

Financial Services Risk and Regulation

FSRR Hot Topic

LIBOR and reference rate reform

LIBOR measures the market for unsecured wholesale term lending to banks. With transactions in the market on the decline, LIBOR is increasingly based on expert judgment. The FCA secured the agreement of the 20 panel banks to continue contributing input data to LIBOR through 2021, pending replacement.

Replacing a benchmark used in \$350 trillion in financial instruments will require considerable effort over an extended period.

EU-supervised users subject to BMR must have robust written plans for replacing LIBOR and insert fallback provisions in new contracts as of 1 January 2018.

Now that MiFID II has gone live, firms will rightly begin to turn their attention to other issues of regulatory importance. One of these is the potential replacement of the London Interbank Offered Rate (LIBOR), a financial benchmark linked to more than \$350 trillion in financial instruments.

In a speech last year on '*The Future of Libor*', FCA Chief Executive Andrew Bailey announced that a replacement for LIBOR was needed with a definitive timeline for transition. LIBOR measures the market for unsecured wholesale term lending to banks. With activity in the wholesale funding market on the decline, LIBOR is increasingly based on expert judgment. While the use of discretion is permissible, transaction data more accurately reflects the underlying market the benchmark intends to measure. To that end, central banks, regulators and market participants are developing transaction-based alternatives.

The FCA announced in November 2017 that it had secured the agreement of the 20 panel banks to continue contributing input data to LIBOR through 2021, pending transition to alternative benchmarks. Meanwhile, the Bank of England (BoE), US Federal Reserve and other global central banks have stepped up efforts to identify transaction-based, risk-free reference rates (RFR) to replace LIBOR.

In this paper, we address four key questions:

- Is this the end of LIBOR?
- What will replace LIBOR?
- What is the impact of the new EU Benchmark Regulation (BMR) on LIBOR?
- What should firms be doing now to prepare for LIBOR replacement?

The end of LIBOR?

In July 2014, the FSB *proposed* standards for the reform of interest rate benchmarks in response to the manipulation scandals of the early 2000s. The Board recommended the use of transaction-based input data and the development of alternative RFRs. The EU subsequently incorporated these standards into the new *BMR* which came into force on 1 January 2018 (subject to transitional provisions).

With more than \$350 trillion in financial instruments which use LIBOR as a reference rate, the market anticipates that resolution of LIBOR may be possible "within four to five years but not less" according to Bailey. On 24 November 2017, the FCA announced that the 20 panel banks which submit input data to LIBOR in five currencies (USD, GBP, EUR, CHF and JPY) *agreed* to continue their contributions until the end of 2021.

While BMR permits national competent authorities (NCAs) to impose mandatory contributions for critical benchmarks such as LIBOR, the period is limited to 24 months. Given the importance of LIBOR to global financial markets, it is unclear whether the end of mandatory contributions in 2021 would immediately result in the end of LIBOR. According to *Jerome Powell*, member of the US Federal Reserve Board of Governors, "Of course, LIBOR may remain viable well past 2021, but we do not think that market participants can safely assume that it will." Nevertheless, in the short term, EU-supervised entities that contribute to or use LIBOR should prepare for potential adjustments in the underlying methodology and input data as a result of BMR.

LIBOR replacements

Transaction data for LIBOR has decreased, significantly for some tenors. Consequently, contributions are increasingly based on inherently less reliable discretion and expert judgment. UK and US central banks have already identified alternative RFRs denominated in GBP and USD based exclusively on transaction data. Other global central banks and industry bodies are developing replacements for similar benchmarks.

GBP LIBOR

The BoE *selected* the reformed Sterling Overnight Index Average (SONIA) to replace sterling LIBOR. In collaboration with the FCA, the BoE *mandated* that its Sterling RFR Working Group implement the transition by 2021 when mandatory LIBOR contributions end. The working group, which was previously limited to banks and broker-dealers, is now open to investment managers, non-financial corporates, financial market infrastructures and trade associations.

Despite these efforts to identify an appropriate replacement, some market participants remain

reluctant to switch to *overnight* rates as an alternative for LIBOR *term* rates. The expanded working group will be tasked with developing term SONIA rates. The BoE plans to issue a consultation paper in the first half of 2018.

USD LIBOR

The US Federal Reserve's Alternative Reference Rates Committee *developed* the Secured Overnight Funding Rate (SOFR) as a replacement for USD LIBOR. While the sterling RFR, SONIA, is based on an existing benchmark with a modified methodology, SOFR is a new benchmark, whose publication is slated for Q2 2018.

Other IBORs

The reform and replacement of interbank offered rates (IBORs) is not limited to LIBOR. The International Swaps and Derivatives Association has a working group *proposing* replacements for discontinued IBORs.

The ECB is *collaborating* with ESMA, EURIBOR administrator EMMI and its regulator, the Belgian Financial Services and Markets Authority, to develop a euro overnight RFR and implement a plan to transition from EURIBOR by 2020. The ECB recently *consulted* on the development of a transaction-based benchmark and invited market participants to join its working group.

Impact of BMR

The replacement of LIBOR overlaps with the new BMR which came into effect for certain benchmarks on 1 January 2018. BMR governs benchmark administrators, contributors and EU-supervised users. However, most of the requirements fall on the administrators (e.g. oversight, governance, methodology, input data, codes of conduct, authorisation, etc.). BMR only covers benchmarks that are used by supervised entities in the EU.

LIBOR is categorised as a *critical benchmark* under BMR and is subject to the most stringent requirements of the regulation. The failure or cessation of critical benchmarks can result in the instability of financial markets, which is why BMR authorises NCAs to impose mandatory contributions.

Here, we assess two key areas where the interaction between LIBOR and BMR is important.

Representativeness

Under BMR Article 11, input data must 'represent accurately and reliably the market or economic reality that the benchmark is intended to measure'. Although BMR still permits the use of discretion and expert judgment, BMR requires input data for benchmarks to be based on transaction data where 'available and appropriate'. When a benchmark is no longer representative, the administrator must change the

input data, methodology or contributors, or cease providing the benchmark.

LIBOR relies increasingly on discretion and judgment due to the lack of activity in the market for unsecured wholesale term lending to banks. Changing or increasing contributor banks is not likely to restore representativeness since the global markets for unsecured term lending are less active. Contributors and EU-supervised users should prepare for potential changes to LIBOR methodology and input data which may be required as part of its authorisation process. LIBOR contributors should anticipate an enhanced code of conduct.

Fallbacks

Under BMR Article 28(2), EU-supervised users of benchmarks must have robust written procedures in place as of 1 January 2018, indicating actions to take should a benchmark cease or change materially. Some firms are identifying actual alternative benchmarks while others are establishing general procedures for how they intend to identify fallbacks for a range of instruments or family of benchmarks.

ESMA confirmed in recent *Q&As* that contracts entered into after 1 January 2018 should include fallback provisions. EU-supervised users must identify alternatives for LIBOR in new contracts, something that might not be straight forward for many firms. Legacy contracts are to be updated on a best-efforts basis in due course.

What firms should be doing now

Replacing a benchmark used in \$350 trillion in financial instruments will require considerable effort over an extended period. LIBOR replacement will affect investment banks, broker-dealers, retail banks and mortgage firms, asset managers, pension funds, hedge funds and insurers. Since the universe of LIBOR users is broader than the EU-supervised financial services firms subject to BMR, non-EU entities and large corporations will be affected as well.

Financial instruments tied to LIBOR include OTC and exchange traded derivatives as well as credit instruments such as commercial and retail loans, mortgages, structured products and bonds. The same benchmark will not be a suitable replacement for LIBOR in every circumstance.

Consequently, the cessation of LIBOR will clearly have a significant impact firms in many ways. What reference rates will derivatives, loans, mortgages and corporate debt use after 2021? How do firms remediate their legacy contracts which reference LIBOR? How will pricing and risk exposures be affected without LIBOR submissions? How are current business processes affected?

To answer these and many other questions, firms should organise their change programmes over the

short, medium and long term. Immediate priorities for the next three to six months include program mobilisation and impact assessments. Thereafter, firms should transition to program roll-out. Four years may seem a long time, but given the volume of potential changes required to contracts, systems and processes, firms should start assessing the impact now.

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