KEY POINTS

- LIBOR is unlikely to exist after 2021.
- Regulators require replacement by alternative reference rates based on transactions.
- A replacement rate is likely to be subject to much greater scrutiny such that it seems almost inevitable that contractual challenges will arise where a counterparty feels that it is being disadvantaged.
- For retail products the regulatory obligation to treat customers fairly needs to be borne in mind.

Feature

Author Roger Jones

LIBOR: a wider perspective

In this article Roger Jones outlines the challenges of LIBOR discontinuance. He stresses the need for goodwill and compromise on all sides to bring the project to a successful conclusion.

Whilst LIBOR (London Interbank Offered Rate) is probably the best known IBOR it is by no means the only one. However, it provides a good example to assist in understanding the predicament in which the global financial system now finds itself. To give an idea of the scale of the issue, according to the Financial Stability Board Market Participants' Group on Reforming Interest Rate Benchmarks (2014) the notional volumes of outstanding financial contracts indexed to USD, GBP, CHF and JPY LIBOR are estimated to be greater than \$150trn, \$30trn, \$6.5trn and \$30trn and they may well have grown since then. Put another way LIBOR risk is estimated to be many times greater than Brexit risk.

In order to better understand the current and future challenges, it is considered useful to consider a brief history of LIBOR. It was originally created in the 1960s for pricing syndicated loans with growth driven by US legislation. In 1986 the BBA (British Bankers Association) assumed control and published LIBOR until January 2014. Following the financial crisis, the Wheatley Review on LIBOR misconduct took place in 2012 and in 2013 LIBOR became regulated by the FCA. In 2014 IBA (ICE Benchmark Administration Ltd) became the administrator.

The original BBA definition was the rate at which an individual contributor bank could borrow funds, were it to do so, by asking for and then accepting offers in reasonable market size, just prior to 11am London time. Whilst the BBA excluded outliers the calculation was relatively unsophisticated and was not designed to combat deliberate market abuse.

However, over the ensuing years LIBOR morphed into a funding benchmark for everything from corporate borrowing and commodity trading to mortgages and even credit cards and its use grew exponentially. It also encompassed a number of currencies and maturities, some with a very thin market.

Whilst there has been much media and other comment on LIBOR over recent years, it has tended to focus more on alleged trading abuse and market manipulation. The financial impact of this is thought to be relatively modest in global market terms although the reputational damage is more significant. However, in the author's view, a much bigger risk arises from LIBOR underpinning a vast number of non-market contracts some of which run for many years. Indeed, it is understood that LIBOR is still being used as a benchmark in some new contracts. The Wheatley Review made a number of recommendations including statutory regulation, transferring responsibility to a new private administrator, introducing a code of conduct and appointing an oversight committee. Conversely, replacing LIBOR with an entirely different benchmark as opposed to tweaking the calculation was not suggested. However, in his speech of July 2017 Andrew Bailey, Chief Executive of the FCA, made three main points, namely:

- While significant improvements have been made to LIBOR since April 2013, the absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets.
- 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.

Standard market documentation produced by bodies such as ISDA (the International Swaps and Derivatives Association) and LMA (Loan Market Association) contains contingency (or "fallback") provisions that address the possibility of LIBOR becoming unavailable but this only partly addresses the issue.

This leads to two major problems with the agreement with the FCA to continue to produce LIBOR until it is discontinued which is expected to be December 2021. The first is what to replace it with and the second is how to address ongoing contracts, or even new contracts, based on LIBOR. There are minor differences but broadly speaking other IBORs face similar problems although solutions may well differ.

There is an understandable wish on the part of central banks and regulators to move to a so called risk free rate (RFR). Indeed, in July 2018 the FCA, CFTC and FSB released coordinated statements on benchmark reform which concluded that transition must happen notwithstanding that the number of contracts referencing LIBOR continues to grow, fallback clauses are helpful but not a complete answer and synthetic LIBOR is not the solution. Whilst overnight RFRs such as SONIA (Sterling Overnight Index Average) for sterling are relatively easy to determine since there is a deep and liquid overnight market, the further one goes into the future the more difficult it becomes, particularly where market activity is thin. Also, RFRs tend to be backward looking whereas loan markets far prefer forward looking rates particularly since they provide advance visibility as to financing costs.

Biog box
Roger Jones is the Chairman of the TARGET Working Group which is a European banking industry forum which considers TARGET Services including TARGET 2 (settling payments), T2S (settling securities), TIPS (instant payments) and CLM (Central Liquidity Management). Email: jonesrsj@btinternet.com

This is addressed in the Bank of England Working Group on Sterling Risk Free Rates consultation which, inter alia, highlights the appetite within the syndicated loan markets for a term reference rate and details options for the calculation of such a rate. In practice robustness of term RFRs depends largely on liquidity in the derivatives market and varies across different currencies.

Another factor which needs to be taken into account is the EU Benchmarks Regulation. Under this Regulation, oversight requirements for submission-based benchmarks state that input data must be transaction data, if available and appropriate. It must also be verifiable and be sufficient to represent the market or economic reality that the benchmark is intended to measure. At the time of writing it is not clear what proposals will emerge for term SONIA once the results of the BoE consultation have been evaluated but subject to regulatory approval where necessary, the Intercontinental Exchange – ICE is proposing one month and three-month SONIA Futures which are cash settled short-term interest rate (STIR) contracts based on the average Sterling Overnight Index Average (SONIA). No doubt other proposals will emerge. Also, the US Alternative Reference Rates Committee (ARRC) has indicated that it intends to create a term reference rate based on SOFR (the New York Fed Secured Overnight Financing Rate). Other term RFRs known to be under consideration are ESTER (EUR), TONA (JPY) and SARON (CHF). However, it is evident there is no quick and easy solution from the fact that the Sterling RFR Working Group reopened the consultation paper on term SONIA reference rates to seek to ensure that market segments and smaller firms who had been unable to respond are fairly represented in the outcome. The complexity of the issues arising in the calculation of term RFRs is well illustrated by some work undertaken by the European Monetary Markets Institute which suggested the concept of adjusted linear interpolation (that interest rates increase or decrease uniformly between two given rates) from adjacent defined tenors. This envisaged a panel bank's submission rate being calculated as the sum of the linearly interpolated rate at the submission tenor using submission rates at adjacent tenors plus a Spread Adjustment Factor which seeks to correct for the curvature of the money market yield curve. One can only hope that the final term SONIA and similar RFRs in other currencies will be somewhat simpler.

The second and arguably even bigger problem is how to address the issue of contracts and customer agreements containing LIBOR clauses which still exist after 2021 if LIBOR is no longer published. Bearing in mind that LIBOR appears in a wide range of wholesale and retail products with its use ranging across corporate and sovereign bonds, covered bonds, securitisations, derivatives and project, asset and trade financings plus various retail products it seems completely unrealistic to assume that agreement can be reached with all affected parties by end 2021 to change it to a replacement rate(s). A further complication is that particularly in the case of wholesale and corporate contracts there may well be interlinking. It follows that a number of challenges will arise but until more is known about the construction of the term SONIA it is difficult to be precise. In addition, multi-currency contracts are also likely to be affected by term RFRs in other currencies. It may sound obvious but the first challenge is determining an appropriate reference rate. LIBOR has been in existence for several decades and users have tended to accept it. However, a replacement rate is likely to be subject to much greater scrutiny. Consequently, it seems almost inevitable that contractual challenges will arise where a counterparty feels that it is being disadvantaged. Appropriate fallbacks to any replacement rate will need to be determined. Competition concerns could arise if it is judged that such discussion affects pricing. There will undoubtedly be operational challenges such as changes required to IT systems. Other issues are cross product coordination of matching reference rates and cross currency coordination for multi-currency facilities. Some documentation, particularly for retail products may contain a discretionary clause but the regulatory obligation to treat customers fairly needs to be borne in mind. There are no doubt many more challenges but what is certain is that it will not be simple. It is understood that a number of industry and other bodies are working on these issues. A good example of this is the LMA which recently published a revised version of their optional "Replacement of Screen Rate Clause" which allows amendments to be made to facilitate inclusion of a replacement benchmark which is formally selected as a replacement for LIBOR by the LIBOR administrator or by an appropriate regulator or is otherwise accepted by the relevant markets or is deemed appropriate by the requisite majority of lenders and the obligors.

It is apparent that whilst progress has been made much work remains to be done including creating firm definitions for term SONIA and similar rates in other major currencies. However, there are a multitude of different working groups delineated by currency and product which risk inconsistent customer/counterparty outcomes and it is likely that difficult choices will need to be made. There is also an element of tension between regulatory objectives and the scale/complexity of the issues.

In summary migration from LIBOR to replacement RFRs, particularly in respect of term rates, is far from simple and goodwill and compromise on all sides are likely to be needed to bring the project to a successful conclusion. ■

Further Reading:

- The market transition pathway from LIBOR to "risk-free" rates: Is it passable? (2018) 4 JIBFL 209.
- A post-LIBOR world: how will the English courts address legacy contracts after 31 December 2021? (2018) 1 JIBFL 3.
- LexisPSL Banking and Finance blog: Replacing LIBOR: current position and implications for loan agreements.