BANK OF ENGLAND

Speech

Turbo-charging sterling LIBOR transition: why 2020 is the year for action – and what the Bank of England is doing to help

Speech given by

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Introduction

2020 is a critical year for LIBOR transition.

Great progress was made in 2019, particularly in sterling wholesale markets – and I want to give special thanks to the part that ISDA's support and leadership has played in that.

But, with the finish line for LIBOR now clearly in view, there is still a lot of ground to cover – particularly in the cash markets. We need to see another decisive acceleration in effort in 2020 to ensure risk-free rates are adopted across the full range of sterling business, and LIBOR is left behind for good.

The motor racing analogy is apt, because LIBOR transition is complex, fast-paced and – above all – a team effort.

The green lights came on some time ago, and the private sector has been decisively – and rightly – leading from the front. The chronic lack of underlying transactions[1] means that LIBOR is simply too fragile a benchmark to support a sustainable business model – indeed its continued existence poses material risks to financial stability, both in the UK and globally. That's why in the race to say goodbye to LIBOR, it is firms' own business leads, project managers and subject matter experts that are designing and driving the cars, supplying the tyres, and running the pit crews – re-engineering systems, innovating new financial products and services, and delivering them to customers. But it's not just a firm-by-firm effort: it's cross-market too. Under the leadership of Tushar Morzaria, Barclays' CFO, the sterling Risk Free Rate Working Group and its various offshoots have brought together over 200 industry experts to solve collective problems. That includes setting the route map to the chequered flag – the latest version of which was released in January (Figure 1).[2] Amongst many important milestones on that map, the most important is to cease issuance of term sterling LIBOR-linked cash products by the third quarter of 2020.[3]

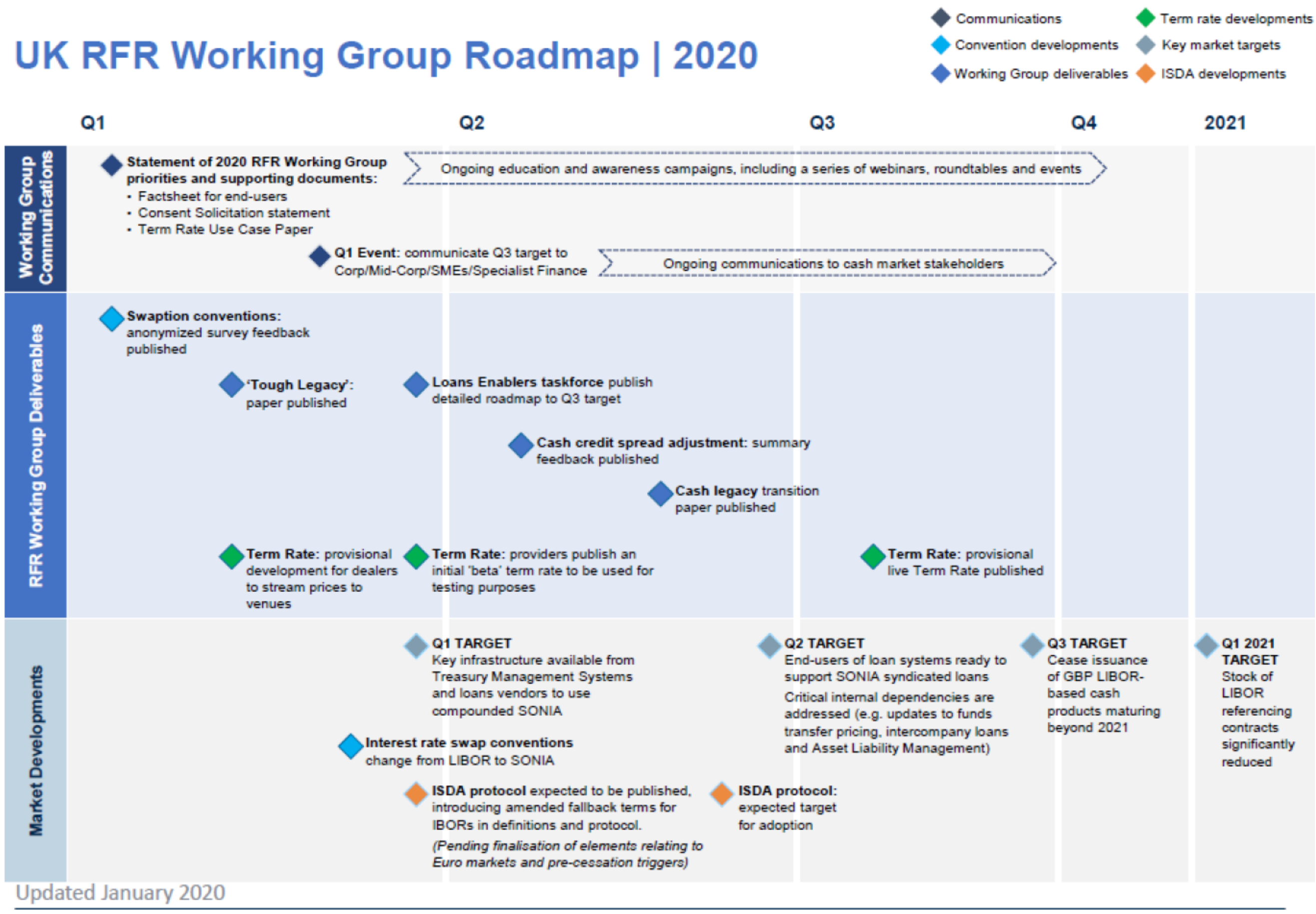
The increased focus and energy from sterling market participants this year is palpable. But they cannot run this race alone. As track marshals and safety officials, the Bank of England and FCA also have important roles to play – and we are using all the tools at our disposal in that quest.

Understandably, perhaps, focus often alights on the 'sticks' we can wield. And it's true that the regulatory authorities have stressed that firms' boards and executives must take ownership of the transition and its key milestones, through 'Dear CEO'[4] and 'Dear Senior Manager'[5] letters, and through direct supervisory

[1] You can see this vividly in the charts at: www.theice.com/iba/historical-data
[2] www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwgs-2020-priorities-and-milestones.pdf
[3] This target refers to products maturing beyond 2021
[4] Dear CEO letter: www.bankofengland.co.uk/prudential-regulation/letter/2018/firms-preparations-for-transition-from-libor-to-risk-free-rates and feedback: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2019/firms-preparations-for-transition-from-libor-to-risk-free-rates.pdf
[5] www.bankofengland.co.uk/prudential-regulation/letter/2020/next-steps-on-libor-transition

engagement. The FCA has set out how it will exercise its powers of life and death over LIBOR, including the critical judgment on representativeness.[6] And the Bank's Financial Policy Committee (FPC) has said that it will consider using other policy and supervisory tools to encourage transition if progress is too slow.[7]

FIGURE 1: Sterling Risk Free Rate Working Group roadmap for 2020



But the public sector has 'carrots' too – and we are doing at least as much to encourage and enable sterling transition as we are to enforce it. The Bank of England has been producing SONIA, the market's chosen risk-free rate, on a daily basis since 2018. With the FCA, we provide the secretariat for the Working Group, helping market participants to identify common goals and targets. We regularly gather structured market-wide information on progress – first through the 'Dear CEO' process and more recently by initiating a regular data collection exercise – and we use it to provide feedback on risks and share good practices. We are working to identify and remove any unnecessary regulatory obstacles to transition, and clarify supervisory expectations.[8] And we help provide international liaison and leadership through the Financial Stability Board's Official Sector Steering Group, co-chaired by Andrew Bailey and John Williams.

[6] www.fca.org.uk/news/speeches/next-steps-transition-libor
[7] www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2019/december-2019.pdf
[8] See for instance www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/prudential-regulatory-framework-and-libor-transition.pdf and www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition

It is in that spirit that I want today to announce two new initiatives aimed at further supporting LIBOR transition:

- First, and in direct response to feedback from market practitioners, the Bank is intending to publish a compounded SONIA index from July 2020. Complementing our existing overnight SONIA rate, the index will provide a flexible tool to help market participants construct compounded SONIA rates in an easy and consistent way, supporting achievement of their 2020 Q3 target for new issuance.

- The second relates to the Bank's own lending operations for banks and other financial intermediaries. From October this year, we will begin increasing haircuts progressively on LIBOR-linked collateral we lend against. This will give firms the time they need to replace that collateral with risk free rate alternatives, ensuring their borrowing capacity is maintained while also protecting public funds. This approach reflects the clear preferences of respondents to our discussion paper last year.[9]

These initiatives are aimed at turbo-charging sterling transition, helping the market deliver against its commitment to transition away from LIBOR and further de-risking sterling markets. More detailed material on both has been published this morning on our website.[10] In the rest of my remarks today, I want to take stock of progress so far, and explain how our new initiatives will work.

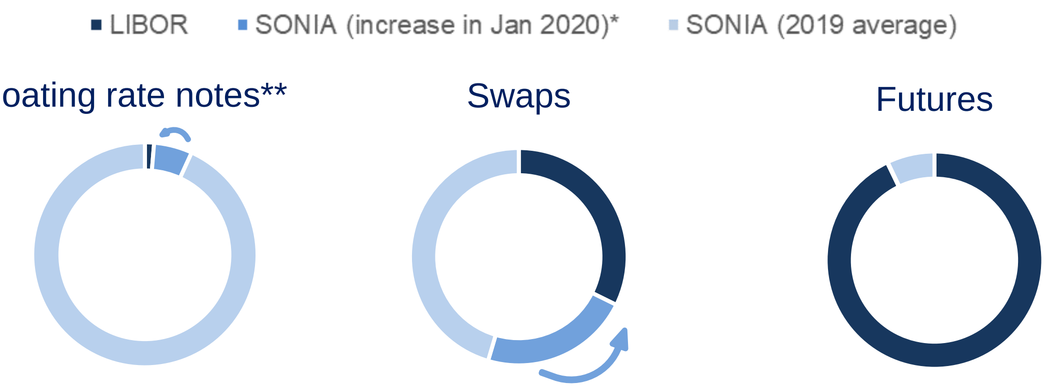
Progress in sterling markets: derivatives instruments

As this ISDA audience will know well, by far the largest sterling LIBOR exposures come from derivatives positions – and progress here has been good. Swaps account for the lion's share of sterling derivatives, by notional value – and last year approximately half of new cleared sterling swaps referenced SONIA. That's some £4 trillion a month. That ratio rose to more than two-thirds in January this year, amidst a sharp rise in trading of expectations on the outcome of that month's monetary policy decision (Figure 2). That demonstrates the depth of liquidity in the market to absorb additional interest.

But we can't rest on our laurels – SONIA usage still needs to be higher. For some time there has been a sense that progress could be accelerated if a way could be found to overcome the potential 'first mover' challenge for intermediaries otherwise keen to switch. For that reason, and following consultation with the industry, the Bank and FCA have strongly encouraged market makers to use SONIA as the standard reference rate for sterling interest rate swaps from 2 March 2020 – that's next Monday. From then, market makers should consider SONIA first.

[9] www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-boes-risk-management-approach-to-collateral-referencing-libor-for-use-in-the-smf
[10] www.bankofengland.co.uk/speech/2020/andrew-hauser-isda-sifma-amg-benchmark-strategies-forum-2020

FIGURE 2: SONIA vs LIBOR Linked Trading Flow Volumes (January 2020)



Sources: Bloomberg Finance L.P., CME Group, CurveGlobal, ICE and LCH Group
* Incremental increase in January 2020 from average SONIA flows in 2019
** Maturing post-2021

This should put the brakes on further increases in the stock of sterling LIBOR swaps maturing beyond 2021 – a metric the FPC has been monitoring closely. And that number should start to go into reverse as contracts mature and others follow the early lead of firms like Nationwide and Legal & General Investment Management – which have publicly switched their balance sheet and client positions respectively to SONIA. As I announced last year, the UK's foreign exchange reserves also now transact only in SONIA-linked contracts.[11]

Even with these sorts of steps, we cannot be sure that the stock of LIBOR-linked swaps will fall to zero in a timely way – and that leaves the system exposed. That's where ISDA's work on fallbacks comes in. While my remarks today focus on new business, I want to thank ISDA for its work – it is a major achievement to have reached consensus on both the structure and the parameters of a market-wide fallback for LIBOR cessation. We welcome the intention to re-consult on the provisions for pre-cessation fallback, and look forward to working with you to deliver on that. Edwin Schooling Latter will talk more to these issues this afternoon.

Having put in place the foundations for a decisive switch in swaps liquidity to SONIA, the next challenge for derivatives markets is to accelerate transition in futures and non-linear products. In preparation for the provision of a robust forward-looking sterling term rate, many banks are now streaming executable SONIA swap prices to regulated trading venues. Having the inter-dealer market able to trade SONIA in a single click is a key building block to helping firms hedge with the smallest friction possible. The Working Group will be considering what more needs to be done to drive transition in these markets over the coming months.

[11] www.bankofengland.co.uk/-/media/boe/files/speech/2019/join-the-revolution-why-it-makes-business-sense-to-move-on-from-libor-speech-by-andrew-hauser.pdf

Progress in sterling markets: cash instruments and lending

If derivatives are well on their way, the big challenge for 2020 is to drive transition in the sterling cash markets – and in particular to hit the market's target of no new issuance of term LIBOR-linked cash instruments after Q3.

We know it can be done. SONIA has quickly become the default reference rate for floating-rate notes and securitisations – accounting for around 85% of new issuance across the two markets in the second half of 2019.

But these are predominantly wholesale transactions, involving a relatively small number of experienced counterparties. Replicating this success in the bilateral and syndicated loan markets – where LIBOR remains the norm – is a different challenge, for at least three reasons:

- First, these markets involve a much wider range of lenders and borrowers, from the most complex global banking groups and largest multinational corporates, to the smallest regional lenders and businesses – many of whom have been distant from earlier stages of the transition effort;

- Second, they rely on a deeply-embedded and relatively fixed infrastructure of pricing conventions, legal agreements and systems; and

- Third, they are largely private markets, making it harder to observe progress using public data and demonstrate change.

Acknowledging these challenges, in 2018 the Working Group broadened its membership to include key participants on all sides of the loan markets. Since then, the Group has undertaken a range of initiatives to explore ways to standardise conventions both domestically and cross-border, meet with loan and treasury systems providers to develop the infrastructure to support SONIA, and standardise documentation. In turn, this work helped support the early examples of sterling SONIA linked loans we saw last year to household names including National Express, South West Water and Associated British Ports.

So, as with wholesale markets, it can be done. But to meet the Q3 target will require a substantial scaling up of what has so far been a cottage industry. Much of the onus for that lies with individual lenders, and many already have pilot loans in the pipeline. That should go a long way towards establishing market norms, testing the investor base, and creating healthy competitive tension between lenders. To support that process, and deal with market-wide issues, a new market-led 'Loans Enablers' taskforce has also been established under the Working Group to identify and deliver incremental tools in four main areas:

- **Conventions** – where the taskforce is working with sterling market participants and international counterparts to finalise key product conventions for new SONIA linked loans;

- **Infrastructure** – where the largest providers of loan valuation and pricing systems now have SONIA-linked loan capabilities, and the taskforce is ensuring new conventions can quickly and efficiently be incorporated into those systems. The group is also identifying typical links across firms' IT systems to ensure alignment across operations, treasury and risk management teams;

- **Documentation** – where the task force is looking for ways to help share lessons learnt on documentation used in firms' pilot loans, in what is largely a private market, allowing others to adapt quickly and standardise where possible. This will complement the important work already underway by the Loan Market Association to revise its own documentation;

- **Communications** – where, despite good progress, there remains an urgent need to expand understanding of the substance and timetable for LIBOR transition to a much wider range of end-users of LIBOR across the UK economy. Central responsibility for this lies with lenders communicating effectively with their clients. But to support that the Working Group recently issued a fact sheet with the Association of Corporate Treasurers, the CBI and the authorities.[12] And a number of other collective initiatives are planned in 2020, including events with a wide range of trade associations, and further materials to help support borrowers to transition.

If those are the challenges facing the private sector, what more can we in the public sector do to assist? Let me talk about the two further steps we are announcing today.

A new compounded SONIA index

Before borrowing firms can transition away from LIBOR-linked loans and bonds, they need to know what rate they will be transitioning to. That rate needs to be fair, verifiable and cost efficient to use.

An early desire to minimise change from the status quo led some initially to look for a forward looking SONIA-based term rate to replace LIBOR. As I have mentioned, UK financial markets are deep enough to allow such a rate to be offered in due course. But a report published last month from a cross-market Term Rate Task Force comprised of both lenders and borrowers showed that, for many types of business, this is a red herring.[13] Broad-based consultation and analysis conducted by the Task Force showed that a far simpler rate, based on overnight SONIA compounded in arrears, can give the desired cashflow certainty for approximately 90% of sterling LIBOR loans (by value), is operationally achievable, and is more straightforwardly consistent with the basis for pricing interest rate hedges.

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[12] www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/factsheet-calling-time-on-libor-why-you-need-to-act-now.pdf
[13] www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf

One challenge sometimes made to the widespread adoption of compounded SONIA is that a degree of expertise, and access to data, is required to calculate the appropriate number. For example, to calculate the compounded interest rate for a three month period requires approximately 60 data inputs (the overnight SONIA rates for each working day of the interest period). In addition, there are a number of ways to calculate the precise compounded rate, depending for example on the convention used for non-business days, or how to round numbers. Uncertainty over such issues could make it harder for some types of non-financial borrower to calculate their interest charge and reconcile it with the various quotes they might receive.

This operational challenge has long been understood, and a number of private sector lenders and infrastructure providers have developed products to simplify these processes for sterling lending. But there have also been increasing calls for a single trusted 'golden source' from which bespoke rates can be calculated, to complement or cross-check those quoted by commercial providers. Similar steps are being taken in other jurisdictions, including the US and Switzerland for dollar and Swiss Franc rates respectively.[14]

The Bank is therefore announcing today our intention to publish a SONIA-linked index from July this year. In addition to the overnight SONIA rate we already publish, this index will allow market participants to calculate a wide range of compounded SONIA rates for longer-than-overnight products by simply using the start and end-date of their product (Figure 3). This approach brings three main benefits for market participants;

- **Ease** – the index will make it easier to calculate compounded SONIA interest rates, requiring only two data points;

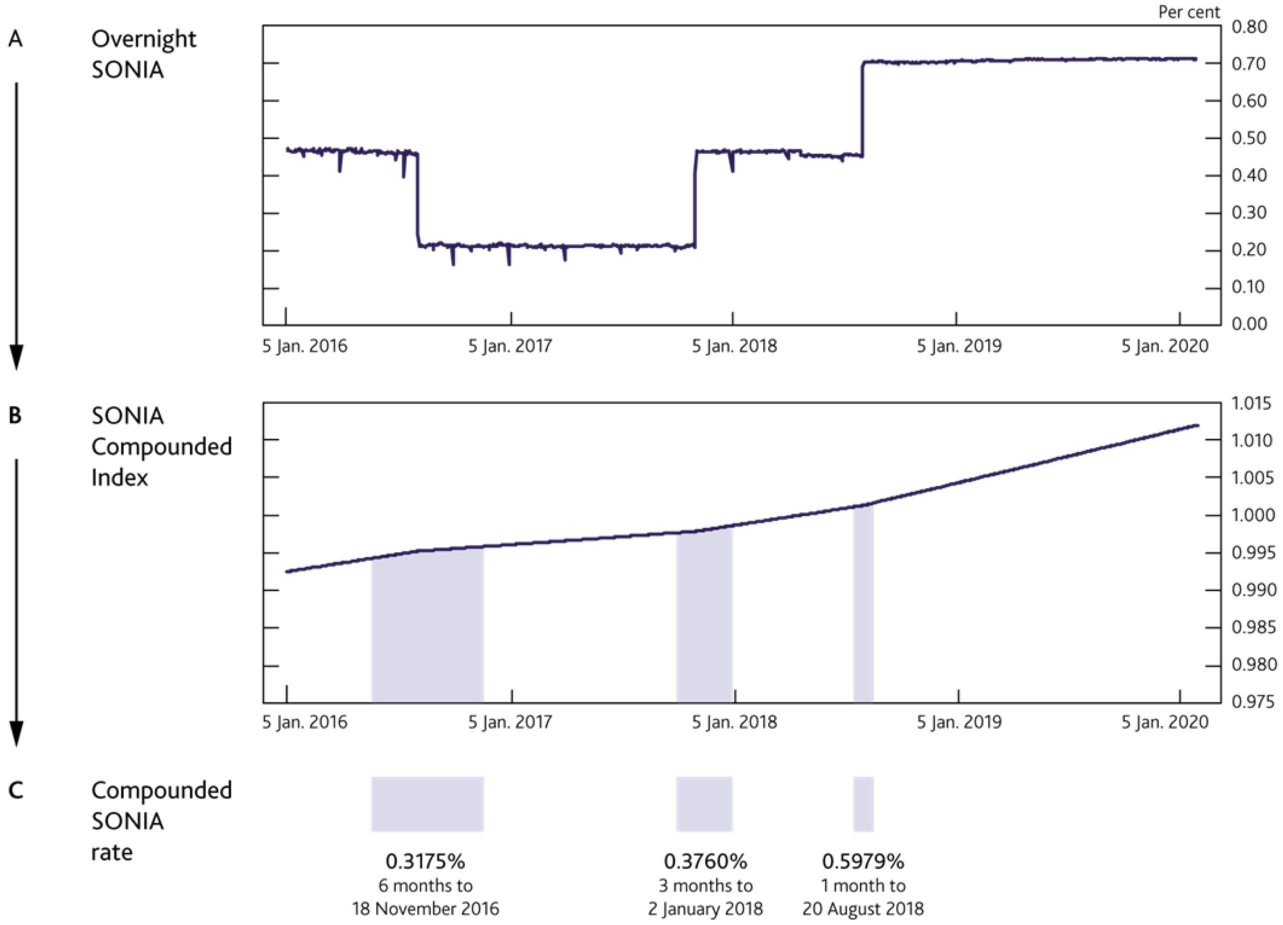
- **Reduction of uncertainty** – the index will use a consistent and standard set of conventions, reducing the scope for confusion over different calculation methodologies, and making reconciliation simpler; and

- **Flexibility** – the index will be publicly available and allow firms and end-users to calculate the compounded rate for products of any combination of start and end dates and any maturity.

We hope that, in time, this tool will complement others already available, helping to build further momentum for LIBOR transition in sterling cash markets – supporting both end-users and loan and infrastructure providers. But these firms should not wait for the index before undertaking their own broader preparations. We already know that new loans and bonds can be issued without the index, based on the range of existing risk free rates and conventions already used in different markets. The SONIA Compounded index will provide an additional, optional tool to complement these, and firms can plan on the basis that the index will be ready to use ahead of the 2020 Q3 target for ceasing new LIBOR issuance.

[14] FRBNY will commence publication of its SOFR Index on 3 March: www.newyorkfed.org/markets/opolicy/operating_policy_200212

FIGURE 3: Overnight Rates, Compounded Index and Compounded SONIA Rates[15]



Some market participants may like us to go one step further by producing daily 'screen rates' for one or more specific period averages – for example 6-month, 3-month or 1-month compounded SONIA rates. Illustrative snapshots of those averages are shown at the bottom of Figure 3. But for screen rates to be of use and drive transition in sterling markets, the specific set of published rates would need to be simple, widely accessible, and based on a clear consensus from the market on the preferred convention to be used. Publishing a large number of alternatives could risk undermining the very certainty that borrowers need.

So, in addition to announcing the index, we are today opening a consultation on whether there is sufficient market consensus for production of a given set of simple period averages, giving market participants the choice between a small number of alternative options. If that consensus exists, we stand ready to work with the market to deliver this complementary tool. We strongly encourage market participants to engage on this consultation and look forward to receiving responses.

[15] For presentational reasons, Figure 3 shows the SONIA index and compound rates over different time periods from those shown in Section 2 of the accompanying Discussion Paper, but the underlying data and calculation methods are identical.

Transitioning the Bank of England's lending facilities away from LIBOR

Our second announcement today also relates to our presence in the market – specifically, how we treat LIBOR-linked collateral in our Sterling Monetary Framework lending operations. We released a discussion paper on this topic last year and today we set out the actions we intend to take.

Our lending operations are designed to provide liquidity support to market participants experiencing either a predictable liquidity need or a firm-specific or market-wide shock. We lend to firms against a wide set of eligible collateral. But to protect public funds we apply a risk-averse 'haircut' to that collateral to protect against possible falls in its value in the period between a counterparty default and collateral sale, including in times of potentially severe stress. The current average haircut on pre-positioned collateral is a little under 25%, giving the Bank a lending capacity of over £300bn after accounting for existing lending (for example under the Term Funding Scheme).

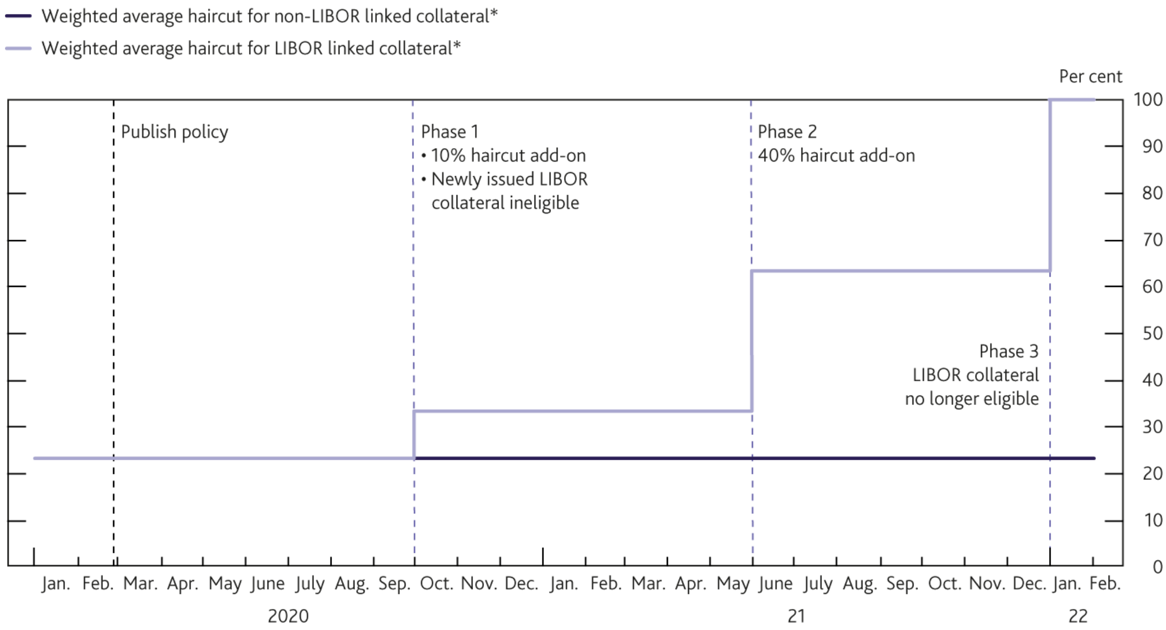
At present, roughly a tenth of banks' drawing capacity is collateralised by assets referencing sterling LIBOR. Those assets include: securities paying a LIBOR-linked coupon; securitisations with embedded LIBOR-linked swaps; and LIBOR-linked loans, in either raw or securitised form. The risk is that, absent appropriate planning, these assets could become increasingly difficult for the Bank to value, risk manage and service as LIBOR cessation approaches. These are activities the Bank must be able to perform in case we have to take that collateral onto our balance sheet in a firm default, in order to protect public funds. A precipitate response to such risks could create a sudden 'cliff edge' reduction in drawing capacity, impairing the availability of effective liquidity insurance at a possibly critical moment.

In order to avoid this risk and ensure that firms' borrowing capacity at the Bank is managed progressively through the LIBOR transition period, we are announcing a new policy for LIBOR-linked collateral to allow firms to plan ahead. There are two key elements, summarised in Figure 4:

- First, from 2020 Q3, we will progressively increase the haircuts on LIBOR-linked collateral pre-positioned with us. Haircuts are scheduled to reach 100% (i.e. implying effective ineligibility) at the end of 2021.

- Second, and in line with the Working Group's 2020 Q3 target for no new term LIBOR loan issuance, any LIBOR linked collateral issued after October 2020 will be ineligible for use at the Bank.

FIGURE 4: Haircut schedule for LIBOR-linked collateral



* Weighted average haircut calculated as at 21 February 2020. Note that haircuts are subject to change.

This graduated approach reflects the clear feedback we received from firms on our discussion paper last year. It is intended to give firms the incentives, certainty and time they need to prepare for LIBOR transition, replacing LIBOR-linked collateral with risk free rate alternatives and maintaining drawing capacity throughout. Careful analysis suggests that this should be a manageable task in the time available, but we will monitor this closely and continue to work with impacted firms on their plans.

Concluding remarks

I began my remarks by comparing LIBOR transition to a motor race. For some, I know it may have felt at times more like a Le Mans endurance race than a Grand Prix. But dawn is at last approaching – and the finish line is drawing nearer. For sterling markets in particular, 2020 is a critical year. The announcements we have made today, coupled with the huge efforts going on right across the private and public sectors, demonstrate I hope that, working together, we can keep sterling markets at the forefront of LIBOR transition.

Thank you.