

Opening remarks by François Jourdain, Chair of the Sterling Risk Free Rate Working Group

Bank of England Roundtable, 6 July 2017

Thank you Governor Carney and Chris Salmon for outlining the key objective of the Working Group on Sterling Risk Free Rate (the 'Group'): to identify and promote a more robust and credible set of interest rate benchmarks, appropriate for many financial contracts like derivatives, thereby improving financial stability.

Of course much work has already been done. The IBOR reforms Governor Carney and Chris Salmon referred to have been underway for a couple of years. Following the directive of the Financial Stability Board (FSB), the Official Sector Steering Group (OSSG) was set up to coordinate the reviews of widely used interest rate benchmarks. The OSSG then established a Market Participants Group (MPG) tasked with identifying feasible and viable alternative reference rates and recommending potential transition paths. After careful analysis, the MPG recommended the development of near Risk-Free Rates (RFR): this required additional work to validate the recommendations and to choose the RFR.

The Group was initiated to assist the Bank of England to meet its objective of developing a sterling RFR. It is a private sector group comprised of senior experts from major sterling swap dealers. Altogether there are 16 voting institutions as well as the Bank of England, the FCA, ISDA and LCH as non voting members.

I see on the screens we now have some answers to the question Chris Salmon asked a short time ago. Chris asked, "What is the main thing you'd like to get out of today's panel discussions?" It seems from the results that there is already a strong understanding of the Group's recommendation of SONIA. This is welcome feedback because transparency is essential. It's very important that the Group objectives are well understood, and that the work it did and recommendations it made are well explained. Glad to see it worked! Going forward, it looks like nearly 70% of you are anticipating a thorough discussion today of the challenges for adoption, and I'm hopeful we'll be able to provide this.

Just before we kick off that discussion though, I think it would be helpful to summarise what we've achieved so far. When we began, we identified some deliverables we believed to be key to a successful process. These were:

- Identify best practices for alternative sterling nearly risk-free, reference rates
- Identify best practices for contract robustness – ISDA is now taking this forward as part of their work on fallbacks, following direction from the OSSG
- Propose reforms for existing sterling nearly risk-free, reference rates
- Develop an adoption plan
- Create a transition plan with metrics of success and a timeline

These objectives are aligned with wider international work towards the FSB's recommendations on benchmark reform. Market participants and authorities in several key markets are working together closely, either through existing industry bodies or through the establishment of working groups. Similar efforts to identify risk-free rates are underway in the US, Japan and Switzerland.

In April 2015, after setting these objectives, the Group agreed to initial criteria for the selection of the sterling RFR. The selection criteria set out key properties for the RFR, such as:

- Availability of sufficient and reliable market data to produce a robust and reliable index
- Clarity of RFR definition and calculation process
- Appropriate representation of market conditions, and
- Ease of implementation and adoption

The Group evaluated all possible candidates and, after careful consideration, selected two key areas of focus: the overnight unsecured and overnight gilt repo markets. The Bank of England Bank Rate, treasury bills, and a hybrid rate were excluded. The unsecured and gilt repo overnight markets were chosen for their concentration of money market transactions and minimal liquidity or credit risk. Quite a bit of work was then done to analyse the underlying markets, to look at size, resilience and any biases that may be present. Useful work on contract robustness was also carried out in the Group, which is now superseded by a dedicated ISDA-led working group.

The Group anticipated that reformed SONIA could be a viable RFR candidate representing the unsecured money market; however there were no sufficiently robust benchmarks representing the secured money market. Therefore in December 2015, the Group published a set of design criteria to encourage the creation of a new, secured, overnight index. I reached out to benchmark administrators to highlight the need for such an index, and helped catalyse the development of Sonet and RIR for the secured market. This allowed the Group to make an informed choice, but also was very useful for the market itself, by providing a new financial index as well as a potential fallback for other rates.

A key component of determining an RFR is the understanding of how the market might transition to it. In the US, neither candidate selected by the Alternative Reference Rates Committee (ARRC) are the incumbent rate, therefore both required an OIS transition. Here in the UK, one of the sterling RFR candidates did not face this challenge. In any event, the Group had many dynamic discussions regarding how the OIS transition necessary to implement a secured RFR could be achieved, in order to better understand the various steps that may be necessary.

The Group also reached out many times to end users to understand sentiment, issues and preferences about these benchmarks and the transition. This was necessary for the integrity of the selection process and contributed to a vibrant debate with strong advocacy for both SONIA and a secured RFR.

In April 2017 the Group announced reformed SONIA was its recommended RFR. There was very strong support for reformed SONIA: 12 of the 16 member firms voted for it as their first choice, and 15 of the 16 member firms supported the majority view on reformed SONIA. This was a strong endorsement for reformed SONIA despite very solid and credible secured contenders.

The other "RFR" groups have also made recommendations: the ARRC in the US recommended the Broad Treasuries Repo Rate (BTRR). In Japan late last year, the Study Group on RFR identified the uncollateralized overnight call rate (TONAR). And earlier in 2016 the Swiss National Working Group (NWG) recommended the overnight secured benchmark rate SARON.

In summary, the first milestone has been hit and now the hard work starts! The Group will now look to undertake a series of actions to advance the adoption of reformed SONIA as the sterling RFR. We will syndicate the recommendation and next steps; that's the purpose of this roundtable. We need to raise awareness of the benchmark reform agenda to a broad set of stakeholders, including you. We

will articulate the rationale for the Group's recommendation and provide an opportunity for constructive feedback. Understanding the concerns of users and stakeholders is very important. We will also communicate SONIA adoption objectives and elicit input on potential adoption strategies. Your involvement here is essential. The Group needs to understand the concerns of users and stakeholders so that we can develop a strategy that has the greatest chance of success. To this end, now that RFR choices have been made, we have greater freedom to coordinate in technical matters with some of the other working groups, in particular with the ARRC, and this may prove helpful.

The Group will help with the development of overnight indexed products and the transition out of Libor for some contracts. We will set what I call the "atomic elements" and conventions, such as averaging, compounding, and maturity extension. This work is already in progress. And it is important. We need to ensure we match the conventions with the needs of the market, and be mindful that different markets have different needs. For example, I started my career trading French Franc swaps that were all indexed on overnight rate, with monthly compounding; it was a very successful benchmark, indexing derivatives, securities and loans. Later in my career, I traded Brazilian Real derivatives: they are all based on overnight rate, with a Business Day over 252 daily compounding. This indexation is still very successful and very adapted to the former hyperinflation in Brazil. We will need to pay careful attention to continuity concerns with existing contracts like SONIA OIS, for instance by keeping the same compounding convention.

Once these elements are in place, we will work to develop the infrastructure needed for the RFR to become an essential part of the financial plumbing. The design of futures contracts, the clearing of long dated swaps, and maturity extensions, are some examples here.

In doing so we will need to be mindful of certain challenges, like the different nature of RFRs on either side of the Atlantic (secured and unsecured) or the potential demand for an ex-ante, forward-looking, setting that replicates the reset mechanism of Libor. And we will have to successfully address them. We will also need to consider what can induce end users to switch out of sterling Libor, such as changing the discounting curve for liabilities. The Group structure will evolve to include representation from end users to better execute our strategy.

To conclude my introductory remarks, I would like to thank the 16 member institutions, LCH, ISDA, the Bank, and the FCA for the incredible effort they've put in to get us to point we are now, for never giving up – even when the road was bumpy – and for always be professional and collaborative.

This can work! In particular, as there is no OIS transition involved, the adoption can happen. And it will happen. Of course some products/actors will still want to use Libor and hopefully this will be on a lot less systematic basis. The corporate loan market is probably the one most intrinsically linked to the IBORs, which presents the question, "Is there a demand to create a maturity extension? And if so, will it be embraced by the market?"

SONIA is very useful for a large number of stakeholders such as insurers, pension funds, banking book hedgers of retail products (often directly or indirectly linked to Bank Rate), and derivatives dealers (Price Alignment Interest). SONIA is a much purer interest rate instrument for investors, hedgers and "traders".

I'm certain the transition will happen. How it will happen will depend on the engagement of all stakeholders, in particular, all the participants of this Roundtable. And this leads to the purpose of our two panels: to shed more light on the recommendation, and to discuss the adoption strategy, to make sure we all have a successful transition.

Closing remarks by François Jourdain, Chair of the Sterling Risk Free Rate Working Group

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As I said earlier, it will happen! In the future many, if not most, wholesale sterling financial contracts will be indexed to reformed SONIA, not to Libor. SONIA is better. It's closer to a real interest rate benchmark not significantly impacted by other considerations such as a credit spread or the regulatory environment. SONIA is stronger. There are lots of transactions! SONIA is safer. It's intrinsically less prone to manipulation. And of course it has the highest standard of administrator. SONIA will relieve the weight on Libor's shoulders.

The key questions are "how?" and "when?" So let me pose a question to you, and please respond via the app: "What is the most important enabler for a transition to SONIA in your business?" This is a free text answer and multiple answers are welcomed.

We need to ensure strong industry coordination. Yes, it may be difficult to make some decisions that might have some short-term costs. But participating in this adoption effort requires mainly your time and effort. The longer-term benefits of a better, stronger and safer sterling benchmark interest rate are worth it!

In addition to the engagement of the Group, the 16 dealers, ISDA, LCH, the Bank, and the FCA, your engagement will make the difference. Your engagement will help to achieve a speedy and wide ranging transition. This effort needs all stakeholders and users to embrace the RFR and ensure a successful adoption.

Please participate in this work. Stakeholder engagement is the key element to success. While the current Group will keep steering the effort, smaller, targeted working groups will welcome representation from all stakeholders.

Thank you in advance. Please do reach out to the Bank's RFR team or to my office. Once again, the success of SONIA adoption hinges on the engagement of all stakeholders – your engagement.