Working Group on Sterling Risk-Free Reference Rates

End User Outreach

19 June 2015 v3.0

Background

In July 2014, the Financial Stability Board published report on major interest rate benchmarks reform
http://www.financialstabilityboard.org/2014/07/r_140722/

In the UK, the Financial Conduct Authority (FCA) is overseeing the reform of Libor (including sterling Libor) and the Bank of England (BoE) is overseeing the development of sterling RFRs

The FSB tasked the BoE and FCA to develop a GBP alternative, nearly risk-free, reference rate (RFR). Certain financial transactions, including many derivative transactions, are better suited to rates that are closer to risk-free. Developing such alternative reference rates meets the principle of encouraging market choice

The BoE, in conjunction with the FCA, initiated the RFR Working Group (WG) to help meet this objective and invited senior subject matter experts from major sterling swap dealers to participate
http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/rfr/rfr.aspx

The key deliverables of the group are to:

- Identify best practices for alternative sterling nearly risk-free, reference rates
- Identify best practices for contract robustness
- 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

At 2 June 2015 meeting, the WG Approved RFR Selection Criteria
http://www.bankofengland.co.uk/markets/Documents/sterlingoperations/rfr/rfrselection.pdf

The Working Group will deliver plans to promote adoption of a RFR amongst a broad cross-section of market participants by December 2015

Criteria to Consider for New GBP RFR - 1 of 3

	Relevance to your business	
1. Basic properties of existing or proposed benchmark	High	Low
a. Assessment v IOSCO and evolving regulatory requirements, e.g.		
• Sufficient and reliable market data to produce robust and reliable index (quantity, quality, availability of data for the administrator)	☐	☐
• Robustness to changes in market structure over time	☐	☐
• Minimal opportunities for market manipulation	☐	☐
• Published and governed by an appropriate administrator	☐	☐
• Commercial sustainability for administrator and data contributors	☐	☐
• Appropriate controls and governance for administrator and data contributors	☐	☐
b. Transparency and sustainability		
• Clarity of definition	☐	☐
• Clarity of calculation/setting	☐	☐
• Acceptable/stable fallback mechanisms	☐	☐
• Clarity in possible future states of the market	☐	☐
• Does not constrain monetary policy	☐	☐
c. Sensitivities – clarity and appropriateness of sensitivities, in present and future, to e.g.:		
• Market conditions		
○ Credit	☐	☐
○ Liquidity premia	☐	☐
○ Period-end effects	☐	☐
• Proximity to policy rate	☐	☐
• Regulatory change	☐	☐
• Changes in the monetary policy framework	☐	☐

Comments

Criteria to Consider for New GBP RFR - 2 of 3

	Relevance to your business	
2. Existence of actual and potential end-user demand for RFR-linked derivatives based on Working Group assessment and outreach to end users	High	Low
a. Suitability as reference rate in wholesale markets (e.g. collateral agreements, swaps, clearing agreements, loans, deposits, FRNs), e.g.		
• Extent to which reflects actual market funding rates	☐	☐
• Benchmark behaves in generally expected manner during normal and non-standard conditions	☐	☐
• Robust and resilient in times of market stress	☐	☐
• Ability to be used as a discount curve and in accounting	☐	☐
• Useable for collateral and other secured scenarios	☐	☐
• Ability to develop futures contracts based on benchmark	☐	☐
b. Suitability as reference rate in retail markets		
• Ease of understanding by non-sophisticated users	☐	☐
c. Assessment of likely end-user demand for RFR derivatives arising from its prospective use as a reference rate in wholesale/retail applications (e.g. does it decrease basis risk in aggregate?)	☐	☐

Comments

Criteria to Consider for New GBP RFR - 3 of 3

3. Other considerations for adoption/transition	**Relevance to your business** High	Low
a. Sterling focussed		
• Ease of calculation	☐	☐
• Ease /low cost of implementation	☐	☐
• Ease of transition from LIBOR [and SONIA] for relevant contracts	☐	☐
• Same day availability (e.g. at close of business)	☐	☐
• Ease of building a term curve extension	☐	☐
b. International considerations		
• Consistent with RFRs chosen for other currencies	☐	☐
• Accepted internationally	☐	☐

Comments

Other Comments on Criteria?

Demand for Term Reference Rate

The WG is focusing on overnight reference rates as these are underpinned by significant transaction volumes. Overnight rates eliminate any term premium, which is consistent with an RFR. However, market participants have historically used interest rate reference rates with longer tenors (e.g. 6-month GBP Libor).

In order to gauge the potential necessity or desirability of term reference rates, please answer the following:	Yes	No
1. Is a term reference rate essential to your business?	☐	☐
2. If "Yes" please explain rationale below	☐	☐
3. Is the development of a term reference rate essential for the overnight rate to become widely used?	☐	☐

Comments (2):

Comments (3):

Other Comments on Term Reference Rate?

RFR Workstreams

Since its initial meeting on 18 March 2015, the WG also has been assessing feasibility of 4 categories of potential RFR benchmarks:

- Unsecured
- Secured
- Bank Rate
- Other (includes Treasury-Bills, OIS, Term Repo)

At the 2 June 2015 meeting, the WG:

- Concluded it would primarily consider Secured and Unsecured RFRs
- Concluded it would apply additional effort to enhance credibility and robustness of existing SONIA and RONIA benchmarks
- Concluded Bank Rate to be considered as a fallback, and eliminated Other

Unsecured

Potential Advantages

Well developed OIS market referencing SONIA

Used as current discounting curve in bilateral pricing and with clearers

~£35Bn daily turnover – brokered and bilateral

Bank of England committed to reform of existing SONIA

Does not constrain monetary policy

Potential Challenges

Retail market less familiar

Volumes have declined and could be reduced further by regulatory environment

Natural fallback option unclear

Secured

Potential Advantages

True indicator of average cost of secured funding

~£35Bn daily turnover – potentially ~£70Bn daily turnover contingent on change in market settlement practices

Variety of data sources from market infrastructure (e.g. LCH, CREST)

Does not constrain monetary policy

Potential Challenges

GC percentage of O/N volumes low

Some consistency issues with trade settlement instructions, obfuscating aggregate activity

O/N volumes could be reduced by Leverage Ratio and NSFR

Natural fallback option unclear - rates may be dependent on collateral demand and supply

Limited use in existing contracts and under-developed OIS market referencing secured rates

Bank Rate

Potential Advantages

Clear, transparent, stable

Immune to manipulation

Potential Challenges

Could constrain monetary policy

May not reflect prevailing market rates

May not be robust to changes in the monetary policy framework

Other

Treasury Bills
Market developments contingent on DMO issuance and fiscal position

Term OIS
Term OIS volumes high (LCH) but may not be enough data granularity for consistent rate on all days

Term REPO
Volumes in term repo are very low compared to overnight (<£2bn)