Preparing for 2022: What you need to know about LIBOR transition

The Working Group on Sterling Risk-Free Reference Rates (‘the Working Group’)

November 2018

The views and opinions set out in this paper and the outputs of the Working Group on Sterling Risk-Free Reference Rates more generally are not necessarily endorsed by the Bank of England (including the PRA) or the FCA

How to use this pack

This pack is designed to inform readers about transition from LIBOR to SONIA. It will be updated periodically to reflect relevant updates

The Working Group encourages interested parties to use this pack when engaging with internal and external stakeholders on this topic.

It covers the following areas

- The problem with LIBOR
- Why SONIA is the preferred alternative
- What firms should be doing
- The role of the Working Group
- Transition challenges
- Working Group milestones
- What's happening internationally

Further information can be found at the Working Group's website

What is the problem with LIBOR?

What is LIBOR?

The London Interbank Offered Rate (LIBOR) is a measure of the average rate at which banks are willing to borrow wholesale unsecured funds. It is administered by ICE Benchmark Administration.

It is calculated based on submissions from selected panel banks and is published in 5 currencies and a range of tenors.

It is a major interest rate benchmark which **underpins c.$300tn ($30tn in GBP markets) of financial contracts** including, derivatives, bonds and loans.

What are the problems?

The underlying market LIBOR measures is no longer liquid.

LIBOR is often used to hedge the general level of interest rates, for which it is inefficient given it includes a term bank credit component.

The FCA has secured panel bank support to continue submitting to LIBOR, but only until 2021. Beyond this date the future of LIBOR is not guaranteed.

***Key fact:** During 2017 on average there was only £187m of 3m deposits per day. For context, 3m £ LIBOR is the most widely used of the GBP tenors*

Figure 1 shows the majority of GBP daily wholesale deposit activity has an overnight maturity rather than the longer maturities measured by certain LIBOR fixings

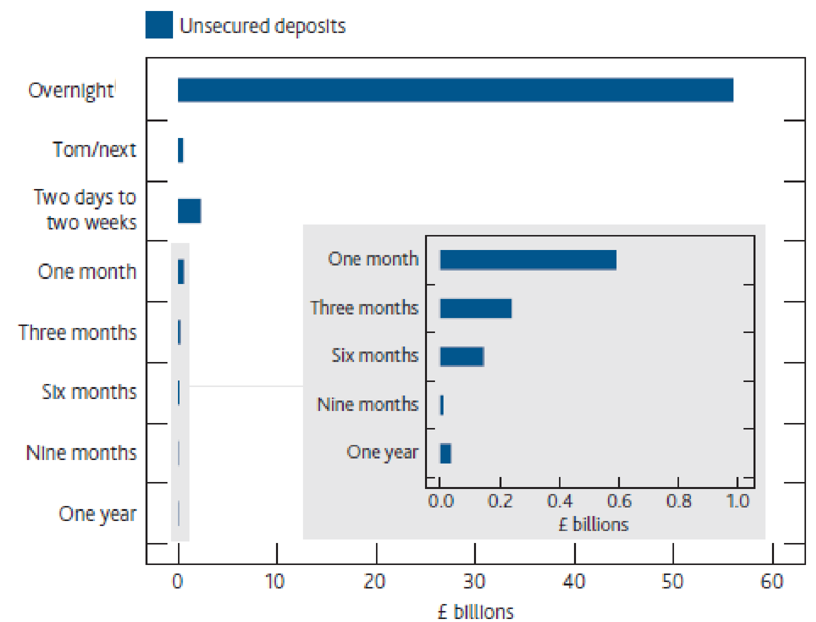
Why should we care?

LIBOR is embedded in firms' operating models. Transitioning to alternative rates will affect how your contracts are priced and how you manage risk.

Contractual fallback provisions in existing transactions may put you at risk of economic value transfer or contract frustration.

There are conduct and legal risks associated with writing long-dated business referencing LIBOR.

Figure 1: Average daily sterling unsecured deposit market volumes (a) (source: Bank of England Quarterly Bulletin Q1 2018)



(a) Daily average from 1 September 2017 to 30 November 2017; only includes transactions of £1m or over

Why is SONIA the best alternative?

What is SONIA?

The Sterling Overnight Indexed Average (SONIA) measures the rate paid by banks on overnight funds. It is calculated as a trimmed mean of rates paid on overnight unsecured wholesale funds

What makes SONIA robust?

SONIA is robust because it is anchored in active, liquid underlying markets.

Key fact: *The average value of transactions underpinning SONIA since April 2018 is c.£45bn per day*

Since April 2018, SONIA has been administered and published by the Bank of England.

Why did the Working Group choose SONIA as its preferred risk-free alternative to LIBOR?

In April 2017, the Working Group recommended SONIA as the preferred sterling risk-free rate citing a number of reasons:

- *SONIA has the capability to evolve over time so is robust to changes in its underlying markets.*
- *SONIA tends to be predictable and tracks Bank Rate very closely.*
- *SONIA is referenced in the already liquid sterling overnight indexed swap (OIS) market making transition easier*

Why use SONIA?

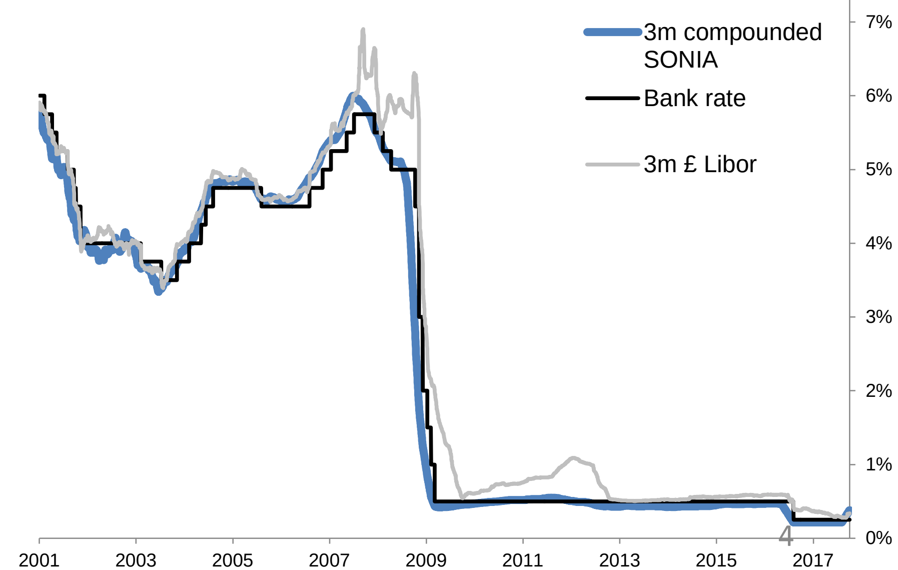
SONIA is robust and sustainable given the volume of transactions underpinning it.

SONIA does not include a term bank credit risk component so is a better measure of the general level of interest rates than LIBOR.

SONIA can be compounded to be used in term contracts. Compounded SONIA tends to be relatively predictable(see figure 2).

Referencing alternatives such as SONIA is the most effective way of avoiding risks related to LIBOR discontinuation.

Figure 2: Base Rate, 3m LIBOR, 3m compounded SONIA time series (source: Bank of England website, Bloomberg, Bank of England calculations



What firms need to do

1. UNDERSTAND EXPOSURES AND RISKS

- Assess the benefits and risks of LIBOR migration
- Consider risk mitigants in a range of scenarios
- Consider regulatory obligations
- Put in place contingency arrangements
- Futureproof documentation
- Consider PRA/FCA Dear CEO letter to largest banks and insurers

2. ACTIVELY REDUCE RELIANCE ON LIBOR

- Get ahead of the problem and plan for transition now
- Provide information on SONIA product offerings to clients, or request information from your advisors
- Use SONIA where possible
- Reduce legacy exposure
- Consider need to transition when transacting products with maturity beyond 2021

3. ENGAGE WITH TRANSITION EFFORTS

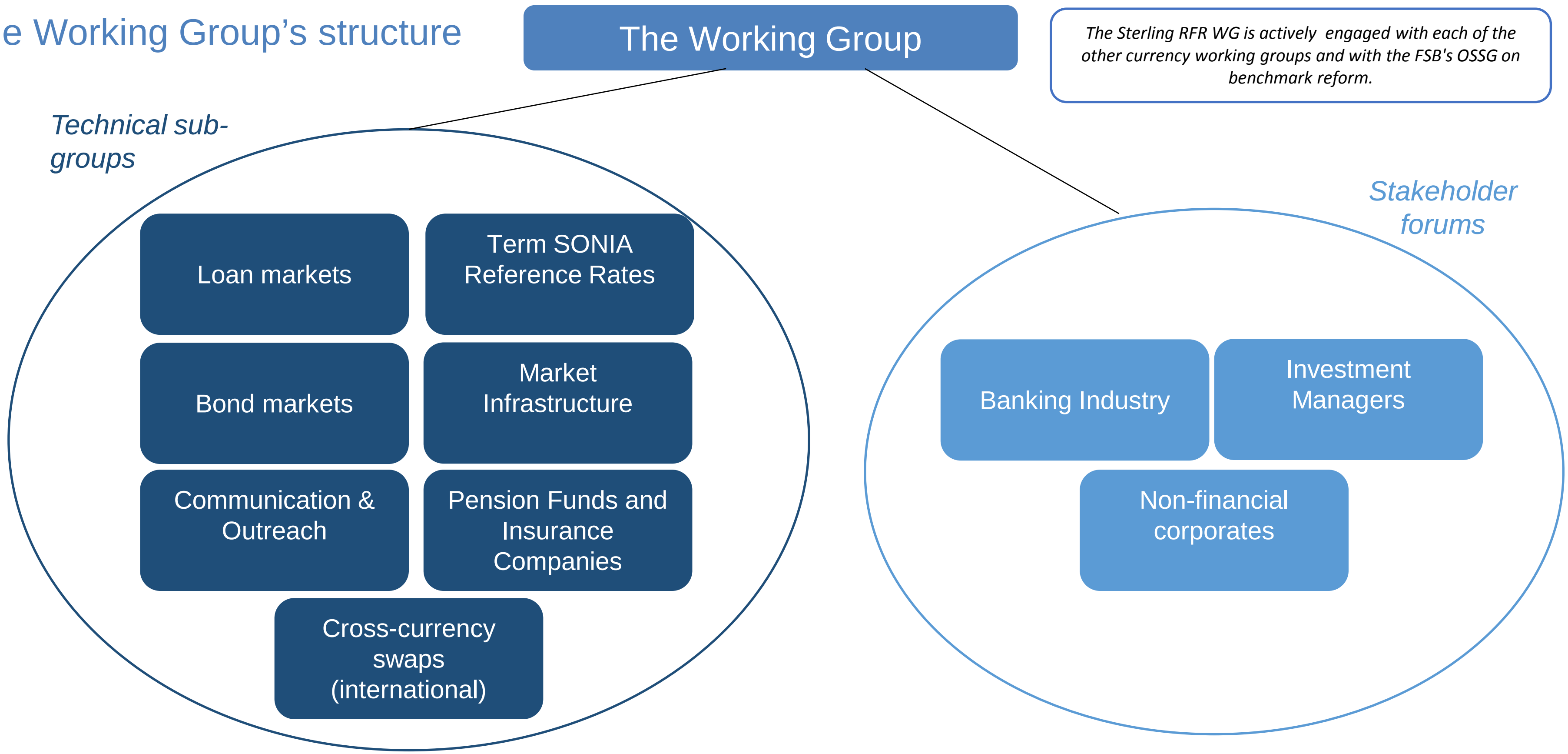
- Tap into market led transition initiatives
- Respond to consultations
- Express interest to RFR Secretariat (RFR.Secretariat@bankofengland.gsi.gov.uk)
- Raise awareness internally and externally
- Set up transition programme internal governance
- Identify senior accountable executive

The role of the Working Group

The Working Group was initially convened by the Bank of England in 2015 to identify the preferred risk-free rate for sterling markets

In January 2018, the Working Group was reconstituted and now includes banks and dealers, investment managers, non-financial corporates, infrastructure providers, trade associations and professional services firms. Its Terms of Reference are available here.

The Working Group's structure



***Key point:** The Group's overall objective is to catalyse a broad-based transition to SONIA by end-2021 across sterling bond, loan and derivative markets*

What are the challenges?

Issue	Working Group action
I can't use SONIA because it's not a forward-looking term rate.	• The Working Group has summarised responses to its consultation on Term Sonia Reference Rates (TSRRs), and will discussed next steps in Q4 2018 • The Working Group anticipates TSRRs could be available in the second half of 2019.
I want to use SONIA compounded over the interest period but my systems are based on LIBOR.	• The Working Group is due to publish a discussion paper on options for referencing SONIA across bond, loan and derivative markets in the coming weeks.
Market infrastructure is not sufficiently developed for using SONIA.	• The Market Infrastructure sub-group will establish a list of infrastructure and operational readiness issues, and seek to engage with technology and infrastructure firms via panels and roundtables to identify solutions to those issues.
I need to use LIBOR while I wait for the development of SONIA market conventions, infrastructure and term rates.	• The Working Group believes that the best way to avoid the risks of LIBOR discontinuation is to transition to alternatives but recognises that this is not always possible • The Working Group has published a document highlighting the risks of issuing LIBOR referencing bonds • The Working Group has published template language for new LIBOR loan contracts to facilitate discretionary transition away from LIBOR • Transition metrics demonstrate evidence of adoption of SONIA across certain markets.

What are the challenges?

Issue	Working Group action
My LIBOR contracts aren't written to deal with permanent discontinuation of the rate.	• ISDA is consulting on potential fallbacks to LIBOR for derivative contracts. These fallbacks would be derived from RFRs and the consultation concerns the appropriate term and credit adjustments. • Based on consultation responses, ISDA will develop and publish amendments to the 2006 ISDA definitions and a protocol to include the amended definitions in existing transactions. • This is anticipated for the first half of 2019.
I can't move my legacy positions as there is a lack of conversion mechanisms.	• The Working Group is currently considering legacy issues and solutions and anticipates publishing guidance on this in 2019
I can't use SONIA within the valuation framework for discounting liabilities under Solvency II.	• The Working Group's Pension Fund and Insurance Company sub-group is engaging with EIOPA on this issue.
There is market inertia and I don't want to be the first to transition.	• The Working Group has established a Communication & Outreach sub-group to deliver a communication strategy with regard to the transition • That strategy will include regular outputs such as a monthly newsletter, as well as more targeted engagement to mitigate the inertia.
Some RFRs are secured and some are unsecured – what does this mean for my cross-currency instruments?	• Working Groups have in each currency identified what they consider to be the most appropriate risk-free rate – in each instance these RFRs are likely to track the general level of interest rates closely. • The Working Group engages internationally with other jurisdictions as appropriate. • An international sub-group on cross-currency swaps has been convened. International coordination takes place via the FSB's Official Sector Steering Group.

Working Group Milestones

Q1 2018

Reconstituted Working Group starts

New technical sub-groups established for loan and bond markets

Work begins on updating fallbacks in documentation for cash markets

Q2 2018

SONIA Reforms Implemented 23 April 2018

Firms develop SONIA futures trading infrastructure

H2 2018

Working Group agrees metrics of success to monitor transition developments

Public consultation on term benchmarks based on SONIA derivatives

Working Group communicates best practice for referencing to SONIA across bonds, loans and derivatives

Development of derivatives infrastructure to facilitate voluntary transition

Term benchmark rate consultation responses summarised.

Working Group recommends criteria for the design of term benchmark (*subject to outcome of consultation)*

Working Group has published recommendations on GBP fall-back rates across derivatives, bond and loan markets.

2019

Development of operational capability for SONIA-referencing FRNs, loans and other instruments

Term benchmark rate produced and made available to use *(subject to outcome of consultation)*

GBP fall-back language agreed and implementation begins

Transition metrics demonstrate significant SONIA adoption for new business across derivatives, bond and loan

2020 - 2021

Transition and fallback plans now in place

Post 2021 LIBOR production no longer guaranteed by FCA

What’s happening internationally?

Working Groups have been setup in all jurisdictions and Alternative Reference Rates (ARRs) selected for all currencies.

Jurisdiction	Working Group	Alternative Ref Rate	Rate Name	Administrator	Collateralisation	Publication Date	Description
	Working Group on Sterling Risk-Free Reference Rates	SONIA	Sterling Overnight Index Average	Bank of England	Unsecured	Reformed 23/04/2018 Legacy 31/03/1997	Unsecured rate that covers overnight wholesale deposit transactions
	Alternative Reference Rates Committee	SOFR	Secured Overnight Financing Rate	Federal Reserve Bank of New York	Secured	02/04/2018	Secured rate that covers multiple overnight repo market segments
	The National Working Group on CHF Reference Rates	SARON	Swiss Average Rate Overnight	SIX exchange	Secured	22/09/2009	Secured rate that reflects interest paid on interbank overnight repo
	Study Group on Risk-Free Reference Rates	TONAR	Tokyo Overnight Average Rate	Bank of Japan	Unsecured	30/12/1992	Unsecured rate that captures overnight call rate market
	Working Group on Risk-Free Reference Rates for the Euro Area	ESTER	European Short Term Euro Rate	European Central Bank	Unsecured	October 2019	Unsecured rate that captures overnight wholesale deposit transactions

Useful links

Working Group on Sterling Risk-Free Reference Rates links

- Working Group on Sterling Risk-Free Reference Rates webpage
- Terms of Reference
- Membership
- Milestones document

Relevant official sector links

- Financial Stability Board 2014 report on major interest rate benchmark reform
- Andrew Bailey July 2017 and July 2018 speeches on future of LIBOR
- SONIA Key Features and Policies document
- PRA and FCA Dear CEO letter on LIBOR transition – September 2018