Minutes of the Meeting of the Working Group on Sterling Risk-Free Reference Rates

Tuesday 14 July

Bank of England

Matters decided by written procedure since the previous meeting

1 The Minutes of the meeting of the 2 June and the outreach pack for end-users had been approved.

2 A vote had been held to approve the addition of LCH.Clearnet to the Working Group as a non-voting member. LCH would represent the views of the central counterparty (CCP) sector. The Chair noted that the Working Group had reached out to other major central clearing houses in order to establish contacts and ensure that their input would also be considered.

Revision to the Working Group timeline

3 The Chair and the Bank outlined a proposed change to the original timeline of the Working Group. There had been good progress so far on the outreach to end-users and the workstreams considering the design of secured and unsecured reference rates; however, further work was required before conclusions could be drawn. The Group agreed to defer drawing these conclusions until the autumn.

Update from the vertical workstreams

<u>Sub-group for secured rates</u>

4 The workstream leads presented their draft proposal for the creation of a secured rate. They noted that General Collateral (GC) repo provided the cleanest read on borrowing costs because the rate did not depend on specific characteristics of the collateral. Volumes of GC repo were around one-fifth of the size of the market for stock-specific Repo. Stock-specific repo trades on average 3bps lower than GC repo, and where collateral traded “special” a negative skew was introduced to the distribution of rates. The role of mandatory buy-in rules and a likely reduction of gilt issuance over the medium-term could increase the propensity for gilts to trade special.

5 Overall, the Group agreed that there was a trade-off between the benefit of additional underlying transaction volumes from including stock-specific repo and the potential effect of specialness in repo markets pulling the overall rate lower than a pure funding rate. The Group discussed different calculation methodologies which could be used to counter the skew created by repo specialness. Some members stated a preference for a simple calculation that maximised the volume of underlying transactions. Others felt that calculation methodologies which minimised the impact of outliers could reduce the impact of specialness in repo rates and would therefore be a good compromise. However, it was noted that such methodologies should be robust to changes in market conditions.

6 The Group were invited to express their initial preferences for the specification of a secured rate benchmark: i) to solely use GC repo transactions; ii) to use both GC and stock-specific repo

transactions, with an appropriate calculation methodology to reduce the impact of specialness; and iii) to use both GC and stock-specific repo transactions with a simple volume-weighted mean rate. The majority of members preferred option ii).

Sub-group for unsecured rates

7 The Bank noted that further information on its initiative to collect money market data will be provided at the September meeting of the Group. The unsecured rates sub-group noted that transition planning would be greatly simplified if the chosen RFR was a SONIA successor. They asked LCH to comment on the challenges involved with introducing new products (such as swaps referencing a new secured rate).

8 LCH.Clearnet provided a short summary of the process for developing new cleared products: the lifecycle is typically that products will develop in over-the-counter (OTC) markets, increasing liquidity; only then the product will be recommended to be cleared and the necessary approvals be applied for and gained. Specifically, LCH.Clearnet's internal governance and regulatory sign-off for clearing eligibility require certain prescribed data such as a 10 year historical price series for calculating margin and records of transaction volumes and liquidity. Sourcing such data may be a challenge for new products, and once sourced the data may not itself pass the relevant tests, for example to prove a product is manageable in a default scenario.

9 In addition, LCH.Clearnet noted the precedent for a change in its discount rate – suggesting that a further change was not insurmountable. However, this would need to be agreed unanimously by its members. One option regarding transition could be to provide products using the new RFR in parallel with existing rates, until outstanding transactions either mature or novate to the new RFR.

Update from the horizontal workstreams

10 The lead representatives from each of the workstreams updated the group on their initial outreach to potential end-users of an RFR:

i. Real money investors and hedge funds felt that having a choice of three reliable reference rates operating in parallel would be beneficial. The cross-currency basis swap market would require compatibility of reference rates, which LIBOR currently provides. A slight preference was stated for an unsecured rate, since this was currently used by the market. These investors felt that a natural migration and incentives would be the most appropriate transition process, and that the development of a futures market and issuance referencing the rate would also help. There was no stated need for a term reference rate.

ii. Pension funds and insurance companies typically had a preference for an index which is robust and reliable, with a clear definition and a preference for public sector administration. They felt there was no obvious need for credit and term premia to be included in the rate. But there was concern about potential fragmentation of liquidity and the potential for increased basis risk; most felt that an alignment of the discount factor and the discount rate was desirable. Some felt that it would be too much of a hurdle to move to a new rate if that required re-negotiation of Credit Support Annexes (CSAs), although incentives could be helpful here. In addition, where the chosen RFR matched the Risk-Free Rate mandated by the European Insurance and Occupational Pensions Authority (EIOPA) this would help catalyse transition.

iii. Sovereigns, supranationals and agencies also focused on the need for compatibility of RFRs across currency areas to ensure the cross-currency basis market would function well. In addition, there was a strong preference for a transaction-based RFR. It would likely be a huge exercise to shift all ALM benchmarking towards a new rate, although these participants would be willing to embrace the shift.

iv. Small bank and building society treasuries stated a preference for an RFR with a close proximity to Bank Rate, as well as being robust, simple and transparent. In addition, they said that demand for a new RFR would depend on its usage in retail or commercial products. Some were concerned about an increase in basis risk due to the introduction of a new set of RFRs.

v. Corporate treasuries voiced similar concerns to those of others. However, they noted an additional challenge in changing loan documentation, which will often have a number of parties. A key issue cited was the need for a rate that included term premia. It was noted that corporate treasuries would likely be slow to transition to a new RFR, but the sector were keen to learn more about the proposals.

Regulatory Change and Monetary Policy – presentation of BIS/CGFS Report

11 Ronnie Driver of the Bank presented the findings of a recent BIS Committee on the Global Financial System (CGFS) Report exploring the impact of regulatory change on money markets, central bank operations and monetary policy implementation.[1] The report used demand and supply schematics, based on a mixture of theory and discussions with market participants, to assess the impact of four key regulations – the leverage ratio (LR), the liquidity coverage ratio (LCR), the net stable funding ratio (NSFR) and large exposure limits (LE) – on money market volumes and interest rates.

12 In summary, the cumulative impact of these regulations is very difficult to assess. Different regulations may affect money market volumes and rates in opposing directions. Moreover, in some cases, the precise calibrations of the regulations are still being finalised. In broad terms, activity in short-term money markets is likely to decrease, while the impact on longer-term money markets is less clear and the money market curve is likely to steepen slightly. In addition, the leverage ratio is likely to reduce volumes in secured money markets – in particular, repo traded through matched books – and the LCR is likely to encourage repo secured against non-HQLA assets vis-à-vis HQLA assets; further reducing volumes of sovereign bond repo.

[1] The Report is available here: http://www.bis.org/publ/cgfs54.htm

Commencement of workstream on contract robustness

13 The workstream on contract robustness would be led by the International Swaps and Derivatives Association (ISDA). The workstream would focus primarily on best practices and principles related to transition between reference rates, as well as developing robust contingency mechanisms in the event of concerns regarding the long-term robustness and/or availability of the reference rate.

Private sector attendees

Nick Saggers	**Bank of America-Merrill Lynch**
Francois Jourdain	**Barclays (Chairman)**
Jon Desler	**Barclays**
Laurent Dulout	**BNP Paribas**
Mark Smith	**Citigroup**
Alain Verdickt	**Citigroup**
Laurent Curtat	**Credit Suisse**
John Hilty	**Deutsche Bank**
Jonathan Hall	**Goldman Sachs**
Michael Graham	**Goldman Sachs**
Christophe Rivoire	**HSBC**
Charles Bristow	**JP Morgan Chase**
Christophe Coutte	**Lloyds**
Ed McAleer	**Morgan Stanley**
Freddie Napier	**Morgan Stanley**
Lewis O'Donald	**Nomura**
David Bradley	**Royal Bank of Scotland**
Paul Barnes	**Santander UK**
Richard Tipper	**Société Générale**
Lai Lai Wong	**ISDA (Observer only)**
Philip Whitehurst	**LCH.Clearnet (Observer only)**

Official sector attendees

Ed Ocampo	**Bank of England**
Tim Taylor	**Bank of England**
Rob Harris	**Bank of England**
Ronnie Driver	**Bank of England**
Jan Lasik	**Bank of England**
Carlos Molinas	**Financial Conduct Authority**