BANK OF ENGLAND

Speech

Remarks given at the first meeting of the Working Group on Sterling Risk-Free Reference Rates

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At the first meeting of the Working Group on Sterling Risk-Free Reference Rates, Bank
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Over the past two and a half years, the Bank of England has been firmly committed to benchmark reform. Much has already been achieved by regulators, administrators and market participants. Those achievements include the Wheatley Review of Libor, the development of IOSCO Principles for Financial Benchmarks, the FSB's recommendations on interest rate benchmark reform, and most recently the extension of the UK regulatory framework to cover additional critical benchmarks – including the interest rate benchmarks, SONIA and RONIA.

But there is still much to do. The way ahead was signposted in the July 2014 Financial Stability Board Report, "Reforming Major Interest Rate Benchmarks".

That Report recommended a 'multi-rate' approach involving the strengthening of existing "IBOR" rates (such as LIBOR) by using, to the greatest extent possible, transactions data; and developing alternative near risk-free reference rates (RFRs) for use in derivatives contracts.

The FSB's recommendation to develop alternative reference rates alongside LIBOR recognises that there are, broadly speaking, two main applications for benchmark interest rates: (i) as reference rates in credit products, including bank loans, thereby helping banks to hedge their unsecured funding costs; and (ii) as reference rates in derivatives contracts, whose users are likely to be seeking to hedge exposure to the general level of interest rates, or to hedge secured funding costs.

LIBOR originated as a reference rate for bank loans, and became the dominant reference rate in interest rate swap contracts because it was already the major established reference rate at the time the swap market developed. However market participants' input to the FSB report suggested that many users of derivatives would prefer not to have exposure to banks' term funding costs through LIBOR swaps, and would instead prefer those contracts to reference a near risk-free rate.

This change will not happen spontaneously – liquidity in long-dated swaps is firmly concentrated in contracts referencing LIBOR and no individual player can change that situation. What is required is a collective effort to change market practice.

That is why we have initiated the Working Group on Sterling Risk-Free Reference Rates. It will be tasked with identifying a suitable near risk-free reference rate for sterling markets, and formulating a transition plan to catalyse a change in market practice so that a significant portion of derivatives contracts reference the new RFR rather than LIBOR. I believe that this is a critical component of the interest rate benchmark reform agenda.

Structure of the group

The Working Group we have initiated today is a private-sector group comprised of senior subject matter experts from major sterling swap dealers. Participation is at the invitation of the Bank of England, and we have convened this particular group because our experience of derivatives reform suggests that the swap dealer community can be most influential in catalysing a transition.

It will of course be necessary to reach out to a wide range of stakeholders – but the commitment to change must originate from this group, and this group is best placed to promote adoption amongst the swap user community.

In particular, we expect that you will reach out to CCPs, exchanges, benchmark administrators, and end users – including institutional investors and corporate treasures. The Bank is prepared to facilitate this outreach process by hosting roundtable meetings at the request of the Working Group.

The International Swaps and Derivatives Association will participate in a non-voting capacity and provide guidance on contract robustness and reference rate transition.

Representatives from the Bank of England and the FCA will participate as ex-officio members. The Bank will also provide a secretariat, host meetings, and publish the terms of reference of the Group, meeting agendas and minutes on our website.[1]

Aims of the group and timeline

The rest is up to you. The first task for the Group is to identify the most appropriate near risk-free reference rate for sterling markets. Alongside that you will consider how contracts referencing the rate can be made robust to changes in market structure. We expect these discussions to reach a conclusion during the third quarter of this year.

The Group will then develop an adoption and transition plan over the remainder of 2015, considering the factors that could facilitate adoption of the chosen RFR, as well as metrics of success and a timeline for the transition process. It is anticipated that firms participating in the Working Group will sign letters of agreement to support adoption of the chosen RFR, referencing these metrics. Implementation is expected to begin in 2016.

[1] See http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/rfr/rfr.aspx

We believe that this needs to be a market-driven process and that the choice of RFR is yours to make. However, this is not an academic exercise. A “choice” means that you will be prepared to make meaningful transition commitments over a 12 to 24 month horizon.

Bank of England data collection initiative

Before I hand over to you all to begin the important work of this Group, I want to make you aware of a new initiative the Bank is embarking on, aimed at enhancing our measures of overnight interest rates in sterling markets.

The Bank has a special interest in monitoring the overnight money market because it is a key aim of monetary policy to influence conditions in that market. Understanding developments in money markets is a crucial part of the Bank’s assessment of monetary and financial conditions. It is therefore of considerable importance to the Bank that robust, transparent measures of overnight interest rates are available.

It is also in the interests of sterling markets more broadly that robust benchmarks are available.

The two main existing sterling overnight benchmark interest rates, SONIA and RONIA, are based on the rates paid respectively on unsecured and secured deposits placed via brokers. The volume of transactions underpinning these benchmarks has fallen significantly in recent years, reflecting reduced money market activity as well as a decline in brokers’ share of that activity. The decline in transactions volumes raises questions about the long-term robustness of these benchmarks. That is of particular concern in respect of SONIA, which forms the basis of the sterling overnight indexed swap market, and is referenced in contracts with a gross notional outstanding value in excess of £13tn.

In our view there is a clear need for a more secure and broad-based source of transactions data to support robust overnight benchmark interest rates in sterling markets.

Accordingly, we have reached the conclusion that the Bank of England should collect each day, from banks and building societies active in sterling money markets, data on their sterling overnight deposit transactions. The purpose of this data collection is to secure and improve the information available to the Bank on conditions in money markets, benefiting our analysis of both monetary policy and financial stability.

We have written to around 30 banks who we will ask to participate in this data collection exercise.

The Bank and the Financial Conduct Authority are in discussion with the Wholesale Market Brokers Association, the administrator of SONIA, regarding the future evolution of that benchmark. We believe that the data we plan to collect should, in time, play an important part in providing firmer foundations for this existing benchmark.

Clearly a stronger overnight unsecured benchmark will be a more attractive candidate RFR than is SONIA in its current form. However I want to be clear that the Bank will pursue this data-collection initiative regardless of the outcome of your discussions on RFRs, since we believe it to be necessary for our own monetary policy purposes, and because it is in the interests of sterling markets more broadly to have robust benchmark interest rates in sterling markets.