LIBOR: the countdown to 2021

Helping business understand and prepare for the phasing out of LIBOR beyond 2021

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Introduction
The future of LIBOR (London Interbank Offered Rate) has been a major discussion topic since Andrew Bailey’s speech in July 2017, where he announced that it was the Financial Conduct Authority’s (FCA’s) intention that it would no longer be necessary for it to use its powers to persuade or compel the panel of banks that contribute LIBOR quotes to do so beyond the end of 2021. This has led to significant activity amongst certain market participants and industry bodies, with working groups set up in the UK and globally to assess the implications of moving to alternative benchmarks.

This introductory paper summarises some of the key issues being considered, and activities being undertaken, as financial and capital market participants prepare for the potential cessation of LIBOR beyond the end of 2021. A glossary of key terms is provided at the end of the paper.

It is still too early for any consensus to have emerged on how the transition from LIBOR and other Interbank Offered Rates (IBORs) to alternative benchmarks will be managed. However, at Lloyds Bank, we recognise these changes have important implications for many of our clients. We will continue to engage with clients on market developments as they emerge and we welcome your feedback. Please feel free to discuss any thoughts or concerns with your Relationship Manager.

What is LIBOR?
LIBOR publication dates back to at least 1986 and since then it has grown to become a global benchmark interest rate for financial products.

Currently, a reference panel of between 11 and 16 contributor banks for each LIBOR currency (GBP, EUR, USD, JPY, CHF) submit daily interest rates for various periods up to 12 months. LIBOR is then calculated and published for each relevant currency and tenor using a trimmed arithmetic mean of the submitted rates.

Until contributing banks transition to the IBA Roadmap methodology they are asked to base their LIBOR submissions in response to the question “At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11am?” (As defined in the Intercontinental Exchange (ICE) Benchmark Administration LIBOR Code of Conduct). This dates back to a time when banks utilised the short-term wholesale funding markets to a greater degree than present.

The process is administered by the ICE Benchmark Administration (IBA) and LIBOR was recently designated as a Critical Benchmark under newly formed EU Benchmarks Regulation.

Other important IBORs are EURIBOR (Euro Interbank Offered Rate) and TIBOR (Tokyo Interbank Offered Rate).

Overview

The market LIBOR seeks to measure is no longer sufficiently active. Engagement will be needed from participants across all relevant sectors and markets to transition away from LIBOR.
Why might LIBOR be phased out?

In July 2017 the FCA announced that it was its intention that it would no longer be necessary for it “to persuade, or compel, banks to submit to LIBOR” or “to sustain the benchmark through our influence or legal powers” after the end of 2021. Reasons given by Andrew Bailey, the CEO of the FCA, for its decision included the fact that the market LIBOR seeks to measure i.e. unsecured wholesale term lending to banks, is no longer sufficiently active.

The FCA also announced in November 2017\(^2\) that all current panel banks have agreed to continue with LIBOR contributions until the end of 2021. This is intended to allow sufficient time for a market-led solution to LIBOR transition to be developed and implemented.

The announcements have provided greater impetus for regulators and market participants to accelerate thinking about alternative benchmark rates and the implications of LIBOR and other IBORs potentially ceasing to exist. This has been further reinforced by Andrew Bailey in a speech in July 2018\(^3\) strongly encouraging market participants not to rely on LIBOR’s continuation beyond 2021, and to make plans for transition.

Why would LIBOR cessation be a big deal?

It is widely acknowledged that LIBOR is a key interest rate benchmark for hundreds of trillions of dollars in financial products and contracts worldwide, including corporate loans, derivatives, corporate bonds/FRNs, structured debt products, deposits and mortgages. It also plays a central role for many banks’ internal funding benchmarks and Insurer Solvency II balance sheets.

Where existing contracts run into 2022 and beyond, market participants will likely need to deploy resources to review and amend documentation in order to confirm suitable replacements to LIBOR as the reference rate, depending on the outcome of a market-led solution.

For new contracts struck before 2022, market participants will be minded to employ appropriate fall-back provisions in documentation in the absence of specific replacement benchmark rates.

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An international effort
Since 2014 a number of countries have set up working groups to identify near-Risk Free Reference Rates (RFRs) as part of a G20 initiative, delegated to the Financial Stability Board (FSB), to review and reform critical benchmark rates. The FSB established an Official Sector Steering Group (OSSG), to focus the FSB’s work on the most fundamental interest rate benchmarks.

Each of the RFRs chosen as potential alternatives to LIBOR brings its own challenges. For instance, some are based on secured and others on unsecured transactions. There is also presently a lack of liquidity in markets referencing these benchmarks (where they exist) and none of the solutions identified so far offers a term structure similar to LIBOR. In fact they are all overnight rates, whereas LIBOR tenors go out to one year, with 3 month and 6 month tenors, in particular, being extensively used in derivative and loan / bond markets.

Different countries are at different stages of preparedness for transitioning to an alternative benchmark. In the UK, there already exists a relatively liquid Sterling Overnight Index Average (SONIA) swap market. The US has only recently started publishing Secured Overnight Financing Rate (SOFR) which was followed by the launch of a Futures market. In the Eurozone the alternative near-RFR has not yet been announced let alone having a market that can reference it.

### Alternative benchmark rates being developed in other jurisdictions

<table>
<thead>
<tr>
<th>Industry body / organisation deciding alternative rate</th>
<th>(Near) RFR recommendation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working Group on Sterling RFR set up by BoE</td>
<td>SONIA, an unsecured overnight rate calculated by the Bank of England from eligible transactions reported to them via their Sterling Money market daily data collection process in accordance with form &quot;SMMD&quot;. Reformed SONIA has been published since April 2018</td>
</tr>
<tr>
<td>Working Group on RFR for the Euro Area, formed by FSMA, ESMA, ECB and the European Commission</td>
<td>The ECB announced on the 21 September 2017 that it will develop a euro unsecured overnight interest rate (to be produced before 2020). The features of this new rate will be communicated in 2018</td>
</tr>
<tr>
<td>Alternative Reference Rates Committee, convened by the Federal Reserve</td>
<td>SOFR, a new, broad US Treasuries repo financing rate published since April 2018</td>
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<tr>
<td>Study Group on RFR</td>
<td>TONAR (Tokyo Overnight Average Rate), an uncollateralised overnight call rate</td>
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<tr>
<td>The National Working Group on CHF Reference Rates (NWG)</td>
<td>SARON (Swiss Average Rate Overnight), which references actual market transactions in the Swiss Franc interbank repo market (i.e. secured)</td>
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</table>

* These recommendations will help develop an alternative for LIBOR over time.
What is the Bank of England doing to aid LIBOR transition?
The Bank of England (BoE) has set up a working group on Sterling RFR (the ‘working group’), which has recommended a reformed SONIA as the preferred Sterling RFR as an alternative to GBP LIBOR. The BoE define SONIA as “a measure of the rate at which interest is paid on sterling short-term wholesale funds in circumstances where the credit, liquidity and other risks are minimal”.

The working group has identified that active engagement will be needed from participants across all relevant sectors and markets to transition away from LIBOR. As a result, a number of sub-working groups have been set up, each with a different industry and product focus.

What does the Bank of England SONIA working group do?
The Bank of England SONIA working group has identified the following:

- **Term SONIA reference rates**: Identify whether, for which applications, and for what tenors, term SONIA reference rates may be appropriate.
- **SONIA futures**: Timeframe in which new SONIA futures can begin being traded.
- **Loan markets**: Focus on benchmark transition issues in loan markets.
- **Bond markets**: Focus on benchmark transition issues in bond markets.

Industry sub-groups (e.g. Pensions and Insurance) have been set up to support the transition.

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*BoE SONIA Key features and policies, available at https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/sonia-key-features-and-policies*
Lloyds Bank is preparing itself for IBOR transition, with the primary objective to position the Group for, and engage with clients on, the consequences of potential cessation of LIBOR, and other IBORs, and commence transition work to alternative benchmarks.

Lloyds Bank will continue to engage with clients on market developments as they emerge. In the meantime we recommend clients raise awareness internally of changes that may be coming and keep abreast of future developments.

Lloyds Bank is represented on the BoE Working Group on Sterling RFR, which was initiated to assist the BoE in meeting its objective of developing sterling RFRs. It is also active on a number of the BoE facilitated industry-wide sub-groups that have been set up, including the Loan Markets, Bond Markets, Term SONIA and SONIA Futures sub-groups.

Lloyds Bank is active in Sterling swaps referencing both LIBOR and SONIA and has been facilitating transitions to SONIA for some clients.
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Transition Challenges: Key Areas of Debate

In the UK, reformed SONIA has been selected as the Sterling near-RFR. However, there are a number of challenges to overcome in transitioning away from LIBOR.

Fall-back provisions
Most financial instrument documents include provisions to guide how the interest rates would be set if LIBOR is no longer available for example in a contingency event such as IT failure. However, these were designed to address temporary and not permanent disruptions in relation to LIBOR and are therefore unlikely to provide a long-term solution.

Industry groups including International Swaps and Derivatives Association (ISDA) and Loan Market Association (LMA) have been reviewing their respective fall-back provisions. For instance, ISDA has established a working group to identify and implement new fall-back provisions for certain key IBORs if they are discontinued.

Fall-backs are likely to be based on the relevant RFR, with an adjustment to minimise any value transfer at the point at which the fall-back is triggered. For adhering parties, ISDA has a protocol system for amending legacy contracts which may allow for a relatively streamlined process, though not all derivatives will be documented under ISDA.

LMA is also reviewing its fall-back provisions: it currently provides optional wording for new contracts, allowing for a replacement benchmark in case of an unforeseen event, where the screen rate is unavailable, or more recently, anticipating uncertainty over the future of LiBOR, if a replacement benchmark is adopted, with the consent of the borrower group and majority lenders (instead of requiring all-lender consent5).

No matter whether majority or all-lender consent is required, it is likely to be operationally burdensome to make a change, as each individual loan agreement would need to be amended.

In line with expectations from the Official Sector the market needs to consider, prepare and agree alternatives for an orderly transition.

Considerations in derivative markets
A key concern in derivative markets (and for all other LIBOR referencing products) is that any transition to new reference rates should not result in value transfer from one part of the market to another. This is a particular concern as different segments of the market tend to operate at different tenors along the interest rate curve.

The ISDA working group have a particular focus on the need to avoid value transfer between market participants6, for example, even a simple change such as referencing three-month Overnight Indexed Swaps (OIS) e.g. SONIA swaps, plus x bps instead of three-month LIBOR may result in this due to changes in market value following a change in the benchmark interest rate. How x will be set is also a matter for some debate.

Awareness of benchmark transition needs to be raised. The market needs to consider, prepare and agree alternatives for an orderly transition

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5 LMA publishes revised Replacement of Screen rate clause to provide further flexibility in light of uncertainty over the future of LiBOR, available at http://www.lma.eu.com/libor
6 ISDA Working Draft as of September 1st 2017
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There may also be accounting and tax issues, as many corporates use LIBOR as the RFR for derivative valuation purposes.

Some participants in the pensions Liability Driven Investment (LDI) market that tend to transact collateralised swaps see some benefit in transitioning sooner rather than later to SONIA-based swaps.

For those participants, their derivatives are already typically valued off a SONIA curve and therefore some see an advantage to moving to SONIA-based swaps if there is sufficient liquidity in the OIS market.

**Considerations in loan and bond markets**

A key concern for loan and bond markets is retaining a forward-looking term structure in RFR as an alternative to LIBOR.

One issue is that SONIA is an overnight rate, and backward looking, whereas borrowers and lenders/investors have a preference for certainty of cash flow that can only be provided by a forward-looking measure.

The BoE Term SONIA sub-working group is looking into how a forward-looking rate can be constructed from SONIA. Any vulnerability resulting from relying on another quoted market must be considered and Term SONIA may just be a stop-gap measure, rather than a long term solution, as the market gets used to using a daily compounding SONIA.

A further concern is that the swap market should not change in a different way to the loan and bond markets, as this could give rise to basis risk and volatility in P&L for hedge accounting packages. There needs to be a high degree of cooperation across the various sub-groups established by the BoE and market sectors as well as coordination across IBOR jurisdictions.

The Working Group on Sterling Risk-Free Reference Rates has recently published a paper4 setting out some of the market uncertainties surrounding issuance of bonds referencing LIBOR that mature beyond 2021.

Legal considerations include: changes to new documentation, transitioning to successor rates and amending existing documentation (including amending in accordance with existing requirements), the inclusion of fall-back provisions and the potential for divergence in terms of approaches given the bespoke nature of deals and documents.

The process for transitioning to alternative rates and the practical implications, including potential systems changes, are also key considerations.

**What next?**

There is a possibility of LIBOR continuing in some fashion beyond 2021, perhaps referencing a more limited set of currencies and tenors, but only for legacy contracts and for where transition is not possible. However, the discontinuation of LIBOR should not be considered a remote probability and transition is strongly encouraged. In general, awareness of benchmark transition needs to be raised and transition work needs to accelerate. In the meantime, new loans and floating rate notes continue to reference LIBOR for lack of a term structure in alternatives.

A couple of consultation papers have been published recently. The Sterling RFR Term Sub-group is consulting5 on how Term SONIA may be published and used by market participants. ISDA is consulting6 on fall-back provisions and an appropriate value adjustment for derivatives if LIBOR ceases to exist. Once these building blocks are in place, we expect the transition to alternative benchmarks to accelerate.

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**Countdown to LIBOR reform in the UK**

**Timeline of steps to reform LIBOR in the UK**

- **2012**: UK Government commissioned Martin Wheatley to undertake a review of the framework for the setting of LIBOR with recommendations published in September 2012.

- **2013**: The FSB established an Official Sector Steering Group (OSSG), which comprises senior officials from central banks and regulatory agencies, to focus the FSB’s work on the interest rate benchmarks that are considered to play the most fundamental role in the global financial system.

- **2014**: The FSB undertook a review of benchmark rates and published ‘Reforming Major Interest Rate Benchmarks’.

- **2015**: The FCA announced that it will no longer be exerting its influence and legal powers to pursue banks to submit reference rates beyond the end of 2021; as a result, LIBOR may be phased out by the end of 2021.

- **2016**: FSB regularly publishes progress reports on implementation of the recommendations laid out in the 2014 FSB report.

- **2017**: The working Group on Sterling RFR announced SONIA as its preferred near RFR for use in sterling derivatives and relevant financial contracts.

- **2018 - 2021**: Most provisions of EU Benchmarks Regulation come into effect. LIBOR designated a critical benchmark.

Since the financial crisis, the underlying market LIBOR seeks to measure has slowed down significantly. As a result, the G20 asked the Financial Stability Board (FSB) to review critical benchmark rates, including LIBOR and EURIBOR, and develop plans for their reform.
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Glossary

BOE: Bank of England
ECB: European Central Bank
ESMA: European Securities and Markets Authority
EURIBOR: Euro Interbank Offered Rate
FCA: Financial Conduct Authority
FRNs: Floating Rate Notes
FSB: Financial Stability Board
FSMA: Financial Services and Markets Authority
G20: Group of 19 individual countries plus the European Union
IBORs: Interbank Offered Rates
ICE: Intercontinental Exchange
ICE BA: ICE Benchmark Administration Ltd
ISDA: International Swaps and Derivatives Association
LDI: Liability Driven Investment
LIBOR: London Interbank Offered Rate
LMA: Loan Market Association
NWG: National Working Group
OIS: Overnight Indexed Swap
OSSG: Official Sector Steering Group
P&L: Profit and Loss
RFR: Risk Free Reference Rate
SARON: Swiss Average Rate Overnight
SOFR: Secured Overnight Financing Rate
SONIA: Sterling Overnight Index Average
TONAR: Tokyo Overnight Average Rate

CONTRIBUTORS

ALBERT SHAMASH
Managing Director, Business Development and Innovation, Financial Institutions Lloyds Bank
E: albert.shamash@lloydsbanking.com

STEVE BULLOCK
Head of Benchmark Submission and Supervision, Group Corporate Treasury Lloyds Bank
E: steve.bullock@lloydsbanking.com
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