LIBOR: the countdown to 2021

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

May 2019

By the side of business
Overview

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. Following on from this speech, Andrew Bailey provided a further update in July 2018, where he further underlined the need for markets to transition away from LIBOR.

Following on from the above announcements, the FCA and Prudential Regulation Authority (PRA) wrote to the CEOs of major banks and insurers supervised in the UK asking for the preparations and actions they are taking to manage transition from LIBOR to alternative interest rate benchmarks.

Whilst the letters were sent to the largest banks and insurers in the first instance, the FCA and PRA are encouraging all firms that currently rely on LIBOR to read and reflect on the letter. It is likely that these letters will be a further catalyst for the acceleration of market transition activities.

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.

Engagement will be needed from participants across all relevant sectors and markets to transition away from LIBOR.

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 and we welcome your feedback. Please feel free to discuss any thoughts or concerns with your Relationship Manager.

Contributing banks are required to formulate submissions in accordance with the methodology requirements published by ICE Benchmark Administration (IBA). The process is administered by the IBA and LIBOR has been designated as a Critical Benchmark under recently formed EU Benchmarks Regulation. Other important IBORs are EURIBOR (Euro Interbank Offered Rate) and TIBOR (Tokyo Interbank Offered Rate).

Why is LIBOR likely to 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. In his speech Andrew Bailey, the CEO of the FCA, stated “the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active”.

The FCA also announced in November 2017 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’s speech in July 2018, and subsequent speeches from the FCA, 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 entered into before 2022, market participants will need 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 some of the 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 only started publishing Secured Overnight Financing Rate (SOFR) in April 2018 which was followed by the launch of a futures market. A swap market exists but has been slower to take off. The Alternative Reference Rates Committee (ARRC) in the US has published a paced transition plan with key milestones to transition away from USD LIBOR by the end of 2021. It has also instituted weekly calls to brief the market and take questions.

Alternative benchmark rates developed for all 5 LIBOR currencies

<table>
<thead>
<tr>
<th>Industry body / organisation deciding alternative rate</th>
<th>(Near) RFR recommendation*</th>
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</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 “SMMD”. 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 13th September 2018 that the private sector working group had recommended €STR as the alternative euro risk-free rate. €STR reflects wholesale euro unsecured overnight borrowing costs of euro area banks and is expected to be published from 2nd October 2019</td>
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<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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<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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In the Eurozone, the phasing out of EURIBOR is running at a slower pace than LIBOR. The Euro Short-Term Rate (€STR) is due to be published from 2nd October 2019. The EU Benchmark Regulation (BMR) is being amended to allow regulators to compel submitters to critical benchmarks to continue to submit rates for a period of 5 years if they wish to withdraw from the panel of submitting banks (extended from 2 years currently). There are currently proposed changes to the calculation methodology for both the Euro Overnight Index Average (EONIA) and EURIBOR. Under the proposals EONIA will simply be quoted as €STR plus a fixed spread and is likely to continue to be published until end 2021 (it is often referenced in EUR collateralised derivative contracts). Also under current proposals EURIBOR will be following a similar hybrid methodology as adopted by the IBA for LIBOR.


* These recommendations will help develop alternatives for LIBOR over time.
What is the Bank of England doing to aid LIBOR transition?
The Bank of England (BoE) has initiated 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”⁸. 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.

The working group is publishing a monthly newsletter with key news relating to RFR transition in GBP markets and others.

Sterling RFR Working Groups

The ACT / LMA and other trade bodies are represented at a cross section of the below groups and forums.

Working Group on Sterling RFRs

The Working Group on Sterling RFRs is actively engaged with each of the other currency working groups and with the FSB’s OSSG on benchmark reform.

Technical Sub Groups

- Cross-currency swaps (international)
- Bond Markets
- Term SONIA Reference Rates
- Communications & Outreach
- Market Infrastructure
- Loan Markets
- Pension Funds and Insurance Companies

Stakeholder Forums

- Investment Managers
- Non-financial Corporates
- Banking Industry

⁸ BoE SONIA Key features and policies, available at https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/sonia-key-features-and-policies
Lloyds Banking Group is represented on the 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, including the Loan Markets, Bond Markets, Infrastructure and Term SONIA sub-groups.

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. In the meantime we recommend clients raise awareness internally of changes that may be coming and keep abreast of future developments.

Lloyds Bank is active in Sterling swaps referencing both LIBOR and SONIA and has been facilitating transitions to SONIA for some clients.

In September 2018 Lloyds Bank plc became the first UK Retail and Commercial lender to price a bond using SONIA as its reference rate. It launched the first securitisation referencing SONIA in December 2018.
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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 such as the International Swaps and Derivatives Association (ISDA) and Loan Market Association (LMA) have been reviewing their respective fall-back provisions. ISDA has established a working group to identify and implement new fall-back provisions for certain key IBORs if they are discontinued. Last year they launched a consultation which revealed a market preference for a fall-back to a RFR “compounded set in arrears” calculation with a “historic mean/median” spread adjustment for legacy contracts. The look-back period for the mean/median calculation has not been determined although initial responses express a preference for a period which excludes the volatility seen during the financial crisis. A supplemental consultation has been launched in May 2019 for USD LIBOR and in time will be launched for EURIBOR. A proposal for the look-back period and calculation methodology is expected to be consulted on during Q2/Q3 2019.

For adhering parties, ISDA has a protocol system for amending legacy contracts which may allow for a more streamlined process in some cases, though not all entities use protocols and 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 consent). 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.

Bilateral renegotiations are more difficult in the public bond market and fall-backs may require additional consideration. In the US, the ARRC has discussed potentially approaching the state of New York to seek a legislative release which would clarify the fall-back mechanism if LIBOR is no longer published and avoid widespread disruption to the market. This approach may not be possible in the UK where legislation may not be sufficient to change underlying contracts.

In January 2019, Edwin Schooling Latter from the FCA delivered a speech highlighting contractual fall-backs and the need for market participants to focus on these ahead of any potential cessation of LIBOR. He speculates on how LIBOR may eventually end. For example, following the departure of one or more panel banks, the Regulator may determine a benchmark is no longer representative of the underlying market, and suggests this may be a suitable fall-back trigger. However, he goes on to state “The best and smoothest transition from LIBOR will be one in which contracts that reference LIBOR are replaced and amended before fall-back provisions are triggered”. In line with expectations from the Official Sector (e.g. Regulators and Central Banks) the market needs to consider, prepare and agree alternatives for an orderly transition.

**Considerations in derivative markets**

The ISDA working group has considered fall-backs for LIBOR to an adjusted RFR plus

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10 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

spread adjustment. Proposals for an adjusted RFR are measured against the following criteria: (1) simplicity and ease of calculating; (2) data requirements; and (3) similarity with the structure of Overnight Index Swaps (OIS). Proposals for a spread adjustment are measured against the following criteria: (1) eliminating or minimising value transfer; (2) eliminating or minimising any potential for manipulation; and (3) eliminating or mitigating against the impact of market disruption at the time the fall-back is applied. Even a simple change such as referencing daily compounding SONIA plus x bps instead of LIBOR may result in some value transfer due to changes in market value following a change in the benchmark interest rate. The ISDA consultation discusses this topic and looks at various options.

There may also be accounting and tax issues, as many corporates use LIBOR as the RFR for derivative valuation purposes. Some corporations in the Liabilities 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.

Changes to collateralised derivatives may be caught by EMIR regulation relating to clearing. The Basel Committee on Banking Supervision and the International Organization of Securities Commissions have released a statement advising that amendments to legacy derivative contracts in response to benchmark reforms do not require the application of margin requirements. However, positions may differ under relevant implementing laws.

Considerations in loan and bond markets

A key consideration for certain sectors in the 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 some borrowers and lenders/investors have a preference for certainty of cash flow that can only be provided by a forward-looking measure. The Term SONIA sub-working group is looking into how a forward-looking rate can be constructed from SONIA and in July 2018 they launched a consultation on Term SONIA rates. The consultation acknowledges the need in some areas of the market for a forward looking term SONIA reference rate. In November 2018 they announced a summary of responses to the consultation and potential benchmark administrators have been invited to share views on the development of Term 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.

In the US the ARRC recently published a User’s Guide to SOFR, the document includes information on a potential Term SOFR.

A further consideration is if the swap market changes 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. The International Accounting Standards Board (IASB) is currently discussing recommended treatment for existing hedge accounting. The Board recently approved recommendations to allow the continuance of hedge accounting for LIBOR-linked products but a decision will not be confirmed until late 2019. The IASB will then consider issues arising once the IBOR has undergone reform.

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 published a paper setting out some of the market uncertainties surrounding issuance of bonds referencing LIBOR that mature beyond 2021.

A number of firms (mostly banks) have issued bonds referencing RFRs. To overcome cash-flow challenges, bond issuers have adopted mechanisms to smooth the settlement process. In SONIA referencing bonds we have seen the Interest Determination Date set five days in advance of the interest payment date, enabling market participants sufficient time for calculation of cash flow and settlement. In the US, we have seen a slightly different approach for bonds that reference SOFR. These bonds have typically used a lockout period, where instead of a lag, the same interest rate fixing is assumed for the final few days of the interest period (initially four, or more recently, two days). These conventions in SONIA and SOFR may still evolve and harmonise. A discussion paper exploring these conventions and inviting feedback was issued in March 2019.

Other important 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?

In his July 2018 speech, Andrew Bailey said: “The discontinuation of LIBOR should not be considered a remote possibility” and “the biggest obstacle to a smooth transition is inertia – a hope that LIBOR will continue, or that work on transition can be delayed or ignored. Misplaced confidence is a risk to financial stability as well as to individual firms.”

In the first instance, firms are encouraged to review existing LIBOR exposures and fall-backs, paying particular attention to those which mature after 2021. This review could include the creation of an overall inventory of products and systems used to capture such exposures. Firms are encouraged to transition rather than rely on fall-backs, and if Term SONIA is published or the market adopts alternative solutions (as seen in the bond markets) and once the ISDA consultation process is complete, we expect transition to alternative benchmarks to accelerate.
Phasing out LIBOR – timeline

**UK**

- The Working Group on Sterling Risk-Free Reference Rates announced SONIA as its preferred near risk-free interest rate benchmark (RFR) for use in sterling derivatives and relevant financial contracts.
- Andrew Bailey questions the sustainability of LIBOR in speech to Bloomberg.
- Panel Banks agree to continue LIBOR contributions until end 2021.
- Reformed SONIA first published by BoE in April 2018.
- SONIA futures are traded.

**International**

- Most provisions of EU Benchmarks Regulation come into effect. LIBOR designated a Critical Benchmark.
- SOFR published and SOFR futures start to trade.

- One year after his first speech Andrew Bailey reinforces message that market should not rely on LIBOR’s continuation beyond 2021.
- Working Group on RFRs invites views on TSRRs from benchmark administrators.
- EIB (Jun) and Lloyds (Sep) issue SONIA-linked bonds.
- PRA/FCA Dear CEO Letter.

**2017**

- Working Group on RFRs publishes Discussion Paper on conventions for referencing SONIA in new contracts.

**2018**

- ISDA launches consultation on implementation of fallbacks for IBORs.
- ESTR selected as EUR RFR.
- ARRC launches fallback consultation: FRNs / loans.
- Fannie Mae and World Bank issue SOFR-linked bonds.

**2019**

- H2: ISDA’s fallback for IBORs likely to be agreed.
- ESTR published by October 2019.

**2020 - 2021**

- Phasing out of LIBOR across all markets.
- LIBOR ceases?

H2/H1 2020: publication of Term SONIA likely to start and ISDA’s fallback for IBORs likely to be agreed.
H2 Liquidity in derivatives referencing SONIA may start to exceed liquidity in derivatives referencing £ LIBOR.
Once the TSRR and ISDA fallback building blocks are in place transition from £ LIBOR to SONIA is likely to accelerate.

Andrew Bailey questions the sustainability of LIBOR in speech to Bloomberg.
Panel Banks agree to continue LIBOR contributions until end 2021.
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SONIA futures are traded.

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Glossary

ACT: Association of Corporate Treasurers
BCBS: Basel Committee on Banking Supervision
BOE: Bank of England
BMR: EU Benchmark Regulation
ECB: European Central Bank
EONIA: Euro Overnight Index Average
ESMA: European Securities and Markets Authority
€STR: Euro Short-term Rate
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
IOSCO: International Organization of Securities Commissions
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
PRA: Prudential Regulation Authority
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
TSRR: Term SONIA Reference Rate

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