LIBOR: What Lies Beneath

July 18, 2018 - Question: What do LIBOR transition efforts and ducks have in common? Answer: While there might not appear to be a lot of action on the surface, underneath there's a flurry of activity going on. We are now beginning to see (and share) what lies beneath.

Last week the official sector declared that market participants should not – cannot! – assume that LIBOR will last forever. While their proclamations might be unnerving, they coincided with positive announcements and momentum. Last Thursday, ISDA announced a market consultation on spread adjustments for derivatives, yesterday the Bank of England released a consultation on term SONIA (sterling risk free rates) and tomorrow the U.S. Alternative Reference Rates Committee will hold a public roundtable to detail its LIBOR efforts so far this year. What does all this mean? We recap and explain below.

The official sector minced no words. Andrew Bailey, the Chief Executive of the U.K.s Financial Conduct Authority (FCA), made 'The case against LIBOR', arguing that "LIBOR is measuring the rate at which banks are not borrowing from one another." In other words, there is very little actual interbank lending or borrowing and hence LIBOR isn't measuring banks' cost of funds. He also said that "the discontinuation of LIBOR should not be considered a remote possibility 'black swan' event. Firms should treat it as something that will happen and which they must be prepared for."

CFTC Chairman Giancarlo also pulled no punches, saying, "the discontinuation of LIBOR is not a possibility. It is a certainty. We must anticipate it, we must accommodate it and we must adapt to it."

Meanwhile, the Financial Stability Board (FSB) explained why markets should want to transition to overnight risk free rates ("RFRs") such as SOFR, rather continue using term interbank markets (like LIBOR). The FSB argued that the RFRs actually are more robust because they are anchored in active, liquid underlying market. (Consider: ARRC pegs daily SOFR repo trading at around $750 billion vs. less than $1 billion for three-month dollar LIBOR.) For this reason, overnight RFRs are the most liquid market and "may also be more appropriate for many users who wish to measure or hedge general interest rate movements."

While those sentiments may be bracing, it's no easy task to transition from the IBORs to new rates – particularly for markets that need term reference rates (i.e., overnight, one week, one month, three month rates, etc.) and a bank credit risk spread component.

But there has been considerable work on this, in both the derivatives markets and the cash markets. Last week, ISDA released a public consultation on that sets out possible adjustments to the RFRs to ensure that, if IBORs were discontinued, legacy derivatives contracts that reference IBORs function. The ISDA adjustments would address two issues. First, the existing contracts reference term IBORs and would need to switch to overnight RFRs. Thus there would need to be a spread adjustment to make the overnight RFR comparable to the term IBOR. Second, IBORs contain a "bank credit risk component", while the RFRs do not. There needs to be a spread adjustment to capture the bank credit risk component. The ISDA consultation discusses these issues and ask for comment. (And for those that argue this process is simple, we'd direct you to Annex A, which is written almost entirely in Greek.)

Of course, efforts are not confined to the derivatives markets. On the cash markets side, yesterday a Bank of England working group released a consultation on developing term rates for SONIA, the Sterling RFR.

This is important for markets like loans. And tomorrow, July 19th, the U.S. ARRC is hosting a public roundtable and webcast where cash market representatives – including the LSTA – will discuss how they are tackling LIBOR fallback language in their particular markets.

The LSTA is a member of the ARRC and co-chairs the ARRC business loans and CLOs working group. For further information, please send questions to LIBOR information@lsta.org. You can also find our Syndicated Loans and LIBOR FAQs on the LSTA website.