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FCA warns, don’t wait to move away from LIBOR

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In a speech given on 15th July at the Securities Industry and Financial Markets Association's (SIFMA) LIBOR Transition Briefing in New York, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority (FCA), urged firms to reduce their stock of "legacy" LIBOR contracts now and ensure they are able to run their business without LIBOR from the end of 2021 when they expect LIBOR panel banks to dwindle or disappear. Bailey emphasised that the base case assumption should be that there will be no LIBOR publication after the end of 2021. The recommendation to move early has been echoed by industry associations including The International Swaps and Derivatives Association (ISDA) in a webcast and FAQs published on their website.[1]

> "Once the FCA has determined LIBOR not to be representative, writing a new contract still referring to the rate involves more conduct risk than I would countenance."
>
> Andrew Bailey July 2019

Problems with LIBOR first came to a head around the time of the financial crisis and the subsequent LIBOR fixing scandal but it wasn't until July 2017 that the FCA announced that it would no longer compel panel banks to contribute to LIBOR after the end of 2021[2] (see also previous Blog "Benchmark Bother") effectively sealing LIBOR's fate. Since then there has been a global benchmark reform exercise between stakeholders, supervisors and international bodies, such as the Financial Stability Board (FSB) Official Sector Steering Group [3] and the International Organization of Securities Commissions[4] (IOSCO), that has sought to transition markets away from using rates, such as LIBOR, which had become largely based on judgment due to lack of real transaction data, by amending the existing methodologies to be more transparent and moving to the more robust risk-free rates (RFRs). The primary

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[1] https://www.isda.org/2019/05/16/may-2019-benchmark-fallbacks-consultations/

[2] https://www.fca.org.uk/news/speeches/the-future-of-libor

[3] Most recently, in June the Financial Stability Board (FSB) published a user guide to overnight RFRs[3]. The guide provides an overview of RFRs, details of how they are calculated, and options on how overnight RFRs can be used in cash products. In doing so the FSB aims to encourage adoption of these rates where they are appropriate.

[4] IOSCO published its *Statement on Matters to Consider in the Use of Financial Benchmarks*, which recommends that parties globally implement plans for a cessation or material change to a benchmark.

measure of such robustness being the volume of underlying observable transactions. To help organise the transition from LIBOR to risk-free rates, authorities set up a series of working groups (such the Sterling Risk Free Rate Working Group in the UK and The Alternative Reference Rates Committee (ARRC) in the US) involving market participants and trade associations, in each jurisdiction. In the UK ISDA, The Loan Market Association (LMA) and The International Capital Markets Association[5] (ICMA) have been particularly active in seeking to address this challenge.

> *"We do expect panel bank departures from the LIBOR panels at end-2021. That is why we keep stressing that the base case assumption for firms' planning should be no LIBOR publication after end-2021."*
>
> Andrew Bailey July 2019

USE of the NEW RFRs

The markets in the alternative RFRs are developing and increasing in liquidity but some markets are further progressed in the move to the new RFRs than others.[6] In all the main jurisdictions, the chosen RFRs are overnight rates, namely SONIA in the UK; Secured Overnight Financing Rate (SOFR)[7] in the US; ESTER in the Euro area; SARON in Switzerland; and TONA in Japan. Recent growth in the use of SONIA futures and swaps as well as its use in floating rate note issuance has been strong. Whereas the take up of SOFR in the US swaps market has not been as quick with USD LIBOR remaining dominant. In addition, whilst a handful of new securitisations are also referencing SONIA there are still many securitisation and other bonds which use LIBOR as the reference rate. Some progress has been made in the loan and bond markets with trade associations working on and producing new standardised documentation[8] for syndicated loans referencing overnight RFRs. The ARRC's recommended fallback language for syndicated loans[9], bilateral loans[10],

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[5] https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/benchmark-reform/

[6] https://www.isda.org/a/J2qME/Interest-Rate-Benchmarks-Review-Q2-2019-and-1H-2019.pdf and https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/statement-on-the-progress-on-adoption-of-risk-free-rates-in-sterling-markets.pdf?la=en&hash=24893EB812640CC61E640BEB98D8E7415439210B

[7] SOFR is a broad measure of the cost of borrowing cash overnight collateralised by US Treasury securities. It is published daily by the New York Fed. https://apps.newyorkfed.org/markets/autorates/SOFR

[8] The Loan Market Association has been working with the US Loan Syndications and Trading Association (LTSA) on standard market provisions to address cessation of LIBOR/ IBORs.

[9] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf

[10] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral_Business_Loans_Fallback.pdf

floating rate notes[11], and securitizations[12] is a significant step and will be very valuable for the market however work remains to be done. The LMA itself acknowledges that there is as yet no obvious alternative to LIBOR for the syndicated loan market[13]. Many loans to UK non-financial borrowers continue to be based on LIBOR rather than SONIA as some such entities prefer the cash flow certainty that term funding provides over adopting the overnight risk-free rates. In addition, some issuers and investors are not yet able to use SONIA because for example they have not made the necessary IT systems changes and they too may be waiting for the development of a SONIA term rate, which is under development by the Working Group on Sterling Risk-Free Reference Rates[14]. Whilst this work is underway UK lenders need to begin engaging with borrowers about lending based on the new risk-free interest rate benchmarks and issuers need to consider how to approach adoption of risk-free rates in the bond markets. One option is to use a backward-looking RFR (e.g. the overnight RFR compounded in arrears for each interest period) or alternatively it may be appropriate in some cases to use a forward-looking term rate derived from the RFRs (once it has been developed). However, the FSB has said it does not expect such RFR derived term rates to be as robust as the RFRs themselves and they should only be used where necessary[15]. LIBOR is also embedded in many risk management and financial accounting practices. For all these reasons the task of migrating away from LIBOR to risk-free rates is a major challenge involving the risk of market disruption and litigation and must not be underestimated.

The derivatives industry is perhaps most advanced in its preparations, with ISDA having conducted a number of detailed consultations (see table below for timeline) and undertaken work on improving the resilience of its fallbacks. The 2000 and 2006 ISDA Definitions used in many derivatives contracts typically provide, in the absence of a rate being published, for a fallback to a rate determined by quotes obtained by the calculation agent from the relevant interdealer market. Whilst such fallbacks work well for minor disruptions they would not work well for a permanent discontinuance. The new IBOR fallbacks under development will fall back to the relevant RFR for the currency and will be adjusted to account for the fact that the RFRs are overnight rates whereas LIBOR is published for varying tenors (the "term adjustment") as well as being adjusted to

[11] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf

[12] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf

[13] https://www.lma.eu.com/libor

[14] https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

[15] https://www.fsb.org/wp-content/uploads/P120718.pdf

account for the risk premia inherent in LIBOR but not in the RFRs (the "spread adjustment"). Once finalised these fallbacks will significantly reduce the risks of widespread disorder in derivatives markets when LIBOR does end. Moreover, it is encouraging that the London Clearing House and (LCH)[16] and Chicago Mercantile Exchange (CME) also intend to adopt the same fallback rates as this will be very helpful in producing a consistent approach across contracts between which there are hedging relationships. Once the IBOR fallbacks are finalised next year for new transactions, adoption of the new IBOR fallbacks will be by way of amendment to the 2006 ISDA Definitions for interest rate derivatives. For legacy contracts it will be achieved by signing a Protocol implementing this fallback arrangement.

Under a related workstream, last September ISDA published its Benchmarks Supplement[17] primarily to help entities comply with the EU Benchmark Regulation requirements for contractual robustness in the event of benchmark disruption. The scope of the Benchmarks Supplement is broader than purely the IBOR rates and could be used for transactions with other floating rates (there are four Annexes for Interest Rates, FX & Currency options, Equity Derivatives and Commodity Derivatives). The 2006 Definitions Benchmarks Annex provides four fallbacks[18] for both an Index Cessation Event and an Administrator/Benchmark Event[19]. The Supplement also contemplates interaction with the up-coming IBOR Fallbacks such that in the event of an "index cessation event" (however described) the IBOR Fallbacks would take priority. However, if there is no "index cessation event" but there is an Administrator/Benchmark Event, then the Benchmarks Supplement fallbacks would apply. The interaction between the ISDA Benchmarks Supplement and the IBOR Fallbacks is explained in ISDA's FAQs[20] but will no doubt need updating in light of the FCA and FSB OSSG suggestions that market participants may wish "pre-cessation" fallback triggers based on an announcement by the FCA that LIBOR is no longer representative, in addition to

[16] https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-isdas-recommended-benchmark

[17] 19th September 2018 https://www.isda.org/2018/09/19/isda-publishes-benchmarks-supplement/

[18] 1. Agreement between the parties; 2. Application of Alternative Pre-nominated Index; 3.Application of Alternative Post-nominated Index and 4. Application of Calculation Agent Nominated Replacement Index.

[19] "Administrator/Benchmark Event" which in essences catches situations where a benchmark has lost (or will lose) its regulatory authorisation, recognition, endorsement, equivalence, approval or is no longer included in an official register and due to that that event a party or the Calculation agent is not permitted by law or regulation to use the relevant benchmark.

[20] FAQs https://www.isda.org/protocol/isda-2018-benchmarks-supplement-protocol/

fallback triggers based on permanent cessation.[21]

The EU Benchmark Regulation (BMR)[22] has provisions aimed at ensuring that a critical benchmark, such as LIBOR, will represent the market or economic reality it is intended to measure. A supervisor of a benchmark administrator has a duty to assess the capability of the critical benchmark to meet this so-called "representativeness test" each time a supervised contributor (i.e. a panel bank) announces that it intends to stop submitting data or in any event, every two years. If the FCA determines that LIBOR is "no longer representative of the underlying market or economic reality," under the EU Benchmark Regulation LIBOR may in some circumstances continue to be published in order to avoid a disruptive cessation and potential financial instability with the FCA has powers to compel contribution under the Benchmark Regulation[23]. The FCA's powers to compel contribution under the Benchmark Regulation can only endure 24 months. Whilst theoretically a LIBOR panel bank could notify its intention to cease providing input data it seems likely (and certainly the FCA hopes) that, as a result of an agreement reached in November 2017 between the FCA and each of the twenty panel banks, LIBOR will continue until the end of 2021[24] and the FCA will not need to use its compulsion powers. So, LIBOR may limp on until the end of 2021 but after that date Bailey warns that it is quite plausible that LIBOR will not meet the representativeness test for three reasons: - a reduced number of panel banks, the panel no longer representing a sufficient share of the market or the market being too thin to measure. He warns that the FCA would not hesitate to make the representativeness judgments that it is required, under law, to make. Such a judgment he believes must be the point at which use of the rate in new contracts

[21] https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks

[22] [22] EU Benchmarks Regulation - REGULATION (EU) 2016/1011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014

[23]The FCA issued a Policy Statement explaining the methodology it would expect to use if it needed to compel one or more banks to contribute to LIBOR. However, at that stage, it did not expect to need to use it. https://www.fca.org.uk/publication/policy/ps18-05.pdf

[24] The notification by a contributor bank that it intends to cease contributing to a critical benchmark, such as LIBOR, triggers an assessment process by its competent authority (amongst others). In such a case the authority (the FCA with respect to LIBOR) has the power under Article 23 of the Benchmark Regulation (and FSMA) to compel contribution but only for a maximum of 24 months. On 24 November 2017, the FCA announced[24] that all 20 of the LIBOR panel banks had agreed to remain as submitters until the end of 2021, by which point it is expected that a transition can be made to alternative rates. And it hopes that as a result of that agreement, it will not need to use the compulsion powers discussed in its policy statement.

> "The best way to avoid the complications of calculating, and explaining, replacement rates is to avoid new LIBOR contracts."
>
> Andrew Bailey July 2019

stops. In such circumstances EU-supervised entities could be prohibited from referencing LIBOR in new derivatives and securities. For this reason, back in January[25] the FCA suggested that market participants may wish to consider including in their LIBOR contracts "pre-cessation" fallback triggers based on an announcement by the FCA that LIBOR is no longer representative, in addition to fallback triggers based on permanent cessation.[26] Likewise the FSB's Official Sector Steering Group expressed a similar view in a letter to ISDA noting that such a trigger "would offer market participants with LIBOR-referencing derivative contracts the opportunity to move to new benchmarks rather than remain on a non-representative LIBOR rate." For these reasons, ISDA's May "pre-cessation" Consultation sought further input on the preferred approach for addressing pre-cessation issues in derivatives that reference LIBOR and certain other critical benchmarks, including in the context of a regulator's statement that the relevant covered IBOR is no longer representative.

So, whilst work is on-going at trade association level it is important for individual market participants to take action now. We urge market participants who have not done so to conduct an impact analysis of the impact of the loss of LIBOR on their new business and legacy contracts with a view to moving over as quickly as possible to using the substitute RFR and quantifying legacy contract impact. Only once the size and nature of the task is established can firms take the necessary commercial decisions to set their approach to handling the cessation of LIBOR. Armed with this information they then need to determine the feasibility of:

- no longer entering into new contracts referencing LIBOR (or indeed other benchmarks likely to cease such as EONIA, EURIBOR). This is particularly important for new contracts maturing after the end of 2021;
- close out existing LIBOR contracts that are due to mature after the end of 2021 or convert to the relevant new risk-free rate (RFR) that has been identified for the relevant LIBOR as part of recent global benchmark reform work e.g. SONIA, SOFR;
- including robust fallbacks in existing contracts referencing

[25] 28 January 2019 https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks

[26] https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks

LIBOR that are due to mature after the end of 2021 triggered by not only permanent discontinuation of LIBOR but also based on an announcement by the FCA that LIBOR is no longer representative.

CONCLUSION

The FCA is doing a good job of sending out a consistent and strong message that market participants need to stop doing new LIBOR business and making the problem ever larger and start finalising their approach to dealing with the legacy contracts either by amending the new RFRs or by including robust fallbacks to the RFRs. Do not rely on LIBOR limping on beyond 2021. The more new contracts that firms are able to write based upon the new RFRs, the smaller the Herculean task of dealing with legacy contracts once LIBOR ceases to be published or ceases to be appropriate as the reference rate (e.g. due to an announcement by the FCA that it fails to meet the representativeness test). Moving legacy contracts over to new reference rates will inevitably create winners and losers and lead to the possibility of disagreement or costly disputes on rights and obligations attached to LIBOR-referencing contracts, and/or to positions being split across multiple different fallback arrangements. Some disputes may be unavoidable but by acting reasonably, in line with supervisory advice and based upon market standard methodology on how to calculate a fair replacement value for LIBOR, market participants can hope to minimise such disputes.

Timeline of ISDA LIBOR and related initiatives

Initiative Date	Summary details

July 2018
 	
Consultation
	• Related to six key IBORs: GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW
	• Consultation relating to certain technical aspects of derivatives fallbacks in particular
	  ○ Term adjustment - to address the need for term rates, and
	  ○ Spread adjustment - to address the difference in risk premia
	• ISDA plans (i) to implement in the 2006 ISDA Definitions for trades on or after the amendment date, and (ii) to provide in a

	Protocol to facilitate amendment of legacy transactions incorporating the 2006 and 2000 Definitions • Covered the proposed methodologies for certain adjustments that would apply to the fallback rate in the event an IBOR is permanently discontinued. These adjustments reflect the fact that the IBORs are available in multiple tenors – for example, 1, 3, 6 and 12 months – but the fallback near risk free rates ("RFRs") are overnight rates. The IBORs also incorporate a bank credit risk premium and a variety of other factors (such as liquidity and fluctuations in supply and demand), while RFRs do not.
September 2018 Benchmark Supplement published	• Covered a much broader range of benchmarks than ISDA's work to implement robust fallbacks to specific rates for certain IBORs. • ISDA published the ISDA Benchmarks Supplement to enhance the contractual robustness of derivatives that reference interest rate, FX, equity and commodity benchmarks.[27] • Primarily intended to facilitate compliance with certain requirements for users of benchmarks in the EU Benchmarks Regulation. • Complements IBOR fallback work, as it enables firms to agree interim fallback arrangements should an IBOR cease to exist before the IBOR fallbacks are implemented. • IBOR fallbacks will take precedence for specified IBORs once implemented, but the ISDA Benchmarks Supplement will continue to provide an additional layer of protection with respect to index cessation in the event an IBOR fallback fails. • It also enables parties to specify primary fallbacks if a benchmark (including an IBOR) is prohibited from use in a derivatives transaction.

[27] The ISDA Benchmarks Supplement is available at: https://www.isda.org/2018/09/19/isda-publishesbenchmarks-supplement/.

December 2018 Report on July Consultation	• Overwhelming majority of respondents preferred the "compounded setting in arrears rate" for the adjusted risk-free rate (RFR) to address the difference in tenors. • Significant majority across different types of market participants preferred the "historical mean/median approach" for the spread adjustment to address the difference in risk premia. • Majority of respondents preferred to use the same adjusted RFR and spread adjustment across all benchmarks covered by the consultation and potentially other benchmarks (such as US dollar LIBOR, euro LIBOR and EURIBOR). • The spread adjustment will vary based on the tenor of the relevant IBOR.
May 2019 Supplemental Consultation [28]	• Supplemental Consultation on Spread and Term Adjustments for Fallbacks in Derivatives Referencing USD LIBOR, CDOR and HIBOR and Certain Aspects of Fallbacks for Derivatives Referencing SOR
May 2019 Pre-cessation Consultation[29]	• Consultation on pre-cessation issues, seeks comment on how derivatives contracts should address a regulatory announcement that LIBOR or certain other IBORs categorised as critical benchmarks under the EU Benchmarks Regulation are no longer representative of an underlying market.
July 2019 Preliminary Results of May	• Consistent with last year's Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW, the overwhelming majority of respondents preferred the "compounded setting in arrears rate" for the adjusted risk-free rate (RFR) and the "historical mean/median approach" for the spread adjustment.

[28] https://www.isda.org/a/n6tME/Supplemental-Consultation-on-USD-LIBOR-CDOR-HIBOR-and-SOR.pdf
[29] https://www.isda.org/a/md6ME/FINAL-Pre-cessation-issues-Consultation.pdf

Supplemental Consultation	• ISDA expects to proceed with developing fallbacks for inclusion in its standard definitions based on the compounded setting in arrears rate and the historical mean/median approach to the spread adjustment for USD LIBOR, CDOR and HIBOR.
c. August 2019 Summary	• ISDA intends to publish aggregated anonymised summary of responses to the May consultations.
c. August 2019 Parameters Consultation	• ISDA will publish a further consultation on the final parameters of the compounded setting in arrears rate approach and the historical mean/median approach to the spread adjustment, which were identified as the preferred approaches for the term and spread adjustment for fallbacks for sterling LIBOR, Swiss franc LIBOR, Japanese yen LIBOR, Japanese yen TIBOR, Euroyen TIBOR and BBSW. • This consultation will now also cover US dollar LIBOR, CDOR and HIBOR.
c. October 2019 Results of August Consultation	• The results of the consultation on the final parameters for these adjustments will likely be published.
October – December 2019	• ISDA plans to finalise the amendments to the 2006 ISDA Definitions to include new fallbacks for sterling LIBOR, Swiss franc LIBOR, Japanese yen LIBOR, Japanese yen TIBOR, Euroyen TIBOR, the Australian Bank Bill Swap Rate, US dollar LIBOR, CDOR, HIBOR and SOR. • Determine the appropriate parameters for the historical mean/median approach to the spread adjustment (including, for example, whether to use a mean or median calculation and the length of the historical lookback period).
December 2019	• ISDA plans to publish the final versions of the amendments, together with a Protocol that derivatives market participants can use to include the fallbacks in existing derivative transactions with other adhering parties.

End Q1 2020 / Start Q2	• The effective date for the amendments to the 2006 ISDA Definitions and the Protocol (at least for parties that have adhered to the Protocol and whose counterparties have also adhered before the effective date) will be approximately three months after the final amendments and the Protocol are made available.

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