HELPING CLIENTS PREPARE FOR THE TRANSITION AWAY FROM LIBOR

APRIL 2020

WHAT IS LIBOR AND WHY IS IT CHANGING?

The London Interbank Offered Rate (LIBOR) has been in existence since the 1970s, but the first official fixings from the British Banking Association started on January 1, 1986. The rate became the cash benchmark for a broad range of financial instruments over time. In 2013, the G20 requested the Financial Stability Board (FSB) investigate reforming LIBOR following a series of regulatory breaches by international banks who were fined for manipulating the rate.

SONIA

The FSB report was published in July 2014[1], and led to the Bank of England (BoE) setting up the Working Group on Sterling Risk-Free Reference Rates in March 2015.

In April 2017, the group selected a reformed version of the Sterling Overnight Interbank Average Rate – SONIA, a rate which has been in existence since 1997 – as the new UK risk free rate. SONIA is calculated based on the interest rate paid on unsecured overnight sterling wholesale transactions of £25m or more, conducted in London by listed money market institutions.

THE END OF LIBOR?

In July 2017, Andrew Bailey, Chief Executive of the Financial Conduct Authority, made a speech[2] in which he declared that the FCA had persuaded LIBOR panel banks to agree to continue LIBOR submissions until the end of 2021, after which it could not guarantee that the rate would continue to exist. Firms were advised to transition away from the rate. A similar process is occurring in other jurisdictions which use LIBOR however whilst the end dates are consistent (end 2021) their timetables and progress are independent of the UK.

Since 2014, the administration of LIBOR has been carried out by Intercontinental Exchange Benchmark Limited (ICE). ICE has taken measures to reform the calculation of LIBOR, with contributing banks shifting to a new 'Waterfall Methodology' from 1 April 2019[3]. ICE is actively engaging with banks globally, with the aim of continuing to publish LIBOR post 2021, but there is no guarantee that the rate will be liquid or pass regulatory tests after this date.

Insight is playing an active role in the interest-rate benchmark reform process:

- In 2017 we created an internal working group to bring together key personnel from across the business. The purpose of this group was to ensure that we were at the heart of the debate, protecting our clients' interests and minimising any disruption to their investments as the market transitions away from LIBOR.
- In 2018 we were invited to join the UK Working Group on Sterling Risk-Free Reference Rates ("RFR"), which was setup by the Bank of England, as it was expanded to include a broader group of industry participants including investment management firms.
- In addition, we have participated in the:
  - RFR Tough Legacy Taskforce, which examines regulatory dependencies associated with LIBOR transition
  - RFR Buyside Forum, which was later replaced by the LIBOR transition working group, hosted by the Investment Management Association, with the aim of facilitating and encouraging benchmark transition amongst buy-side firms
  - ISDA Working Group on LIBOR and the SONIA Oversight Committee, setup to focus on fallback rates in derivative contracts
  - SONIA Oversight Committee, which reviews and challenges all aspects of the benchmark determination and administration process
- Insight is a member of the Loan Market Association (LMA), via BNY Mellon, and receives regular updates on the dialogue between the LMA and relevant parties.
- Insight has taken part in various consultations, including the ISDA Benchmark Fallback Consultation in which we recommended the 'compounded setting in arrears rate' for the adjusted risk-free rate and the 'historical mean/median approach' for spread adjustment. Both of these choices were chosen by the majority of respondents. We believe this approach will minimise uncertainty for clients.

[1] https://www.fsb.org/wp-content/uploads/r_140722.pdf

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

[3] https://www.theice.com/iba/libor

BUILDING PRESSURE TO TRANSITION

On 16 January 2020, the BoE, FCA and the Working Group on Sterling Risk-Free Rates published a set of documents[4] aimed at accelerating efforts to switch to alternative risk-free rates. The group's priorities include:

- ceasing issuance of cash products linked to sterling LIBOR by the end of the third quarter 2020
- demonstrating that compounded SONIA is easily accessible and usable
- taking steps to enable derivatives markets continue to migrate from LIBOR to SONIA
- establishing a framework for transitioning LIBOR legacy products to reduce the outstanding stock of LIBOR based contracts
- considering the best way to address contracts that are less easily convertible, known as 'tough legacy' contracts

The BoE and FCA have also written to major banks, asset managers and insurers[5], setting out their expectations for transition progress in 2020. In this letter firms were advised that:

'The intention is that sterling LIBOR will cease to exist after the end of 2021. No firm should plan otherwise.'

The BoE has also announced that it is intending to publish a compounded SONIA index from July 2020, allowing participants to calculate a wide range of compounded SONIA rates for longer-than-overnight products.

From October 2020, the BoE will start to increase the haircuts for lending using LIBOR-linked collateral, rising over time until they reach 100% by the end of 2021. Newly issued LIBOR-linked issues will ineligible for use as collateral from Q3 2020.

Where client benchmarks reference LIBOR we have an active program to restate these benchmarks with reference to risk free rates or alternative compliant benchmarks if more appropriate.

MARKET IMPACT

Derivative fallback language

ISDA is a trade organisation which creates standardised contracts for the derivatives market. In anticipation that LIBOR may cease to be published, ISDA has been working on fallback language for derivative contracts so that markets could continue to function.

This fallback language will be incorporated into relevant trading documentation through a supplement to the existing industry definitions and an associated protocol. Individual market participants will agree to the changes made in the supplement by adhering to the protocol.

The fallbacks included in the supplement would be triggered if:

- there is a public statement by the LIBOR administrator that it will cease publication of the benchmark
- there is a public statement by the regulatory supervisor of the administrator, or other authorities with jurisdiction over the administer, that the benchmark will cease to be provided

ISDA has reached out to the investment industry regarding this fallback language via a series of consultations.

Insight has responded to the ISDA consultations globally, recommending the use of the 'compound setting in arrears rate' for the adjusted risk-free rate, using the 'historical mean/median approach'. This has been the preference of most respondents. Insight has in a later consultation recommended that the spread be calculated over a five-year period, stressing that global consistency is critical.

If adopted, this would mean that if LIBOR does cease, contracts that reference LIBOR would switch to the new benchmark reference rate plus the median spread between that new benchmark and LIBOR over a five-year lookback period. Rates would not be forward looking as LIBOR is, but calculated by compounding the historical overnight rate over the period.

ISDA aims to have its finalised fallback language incorporated into new documentation by the middle of 2020. Subject to reviewing the final versions of the supplement and protocol, it is Insight's current intention to adhere to the protocol and thus incorporate the fallback language drafted by ISDA into all of the relevant agreements on Insight's agency platform.

Pre-cessation clauses

ISDA has recently consulted on the inclusion of pre-cessation triggers within contract language. A pre-cessation trigger would allow the FCA to announce the cessation of LIBOR if it believes that the published LIBOR rate is no longer representative, even if it still technically exists. This would help to avoid a scenario where, for example, LIBOR continued to be published, but based on a significantly reduced number of bank quotes. As the London Clearing House (LCH) has already included pre-cessation triggers in its clearing documentation, Insight believes that it is vital to ensure consistency between the cleared swap market and the bilateral swap market. This consistency should help preserve market liquidity, and standardisation should ensure fair treatment of all interest rate swap holders.

For ISDA to adopt the pre-cessation triggers, the consultation required a large number of non-bank respondents to take part and agree. As such, Insight engaged with clients in order to highlight the importance of the consultation. On 15 April 2020, ISDA announced preliminary results of the consultation which suggested that pre-cessation triggers will be adopted.

[4] https://www.fca.org.uk/news/press-releases/next-steps-libor-transition-2020-time-act-now

[5] https://www.fca.org.uk/publication/correspondence/dear-smf-letter-next-steps-libor-transition.pdf

Fixed income

Within fixed income markets, most of the securities that reference LIBOR are floating rate notes. In many instances floating rate instruments are often short-dated so a proportion of the underlying assets will have matured or paid down before LIBOR is expected to cease.

For those securities with maturities beyond 2021 that reference LIBOR (typically in terms of the coupon that they pay), a part of our current research process is to identify whether suitable language is in the prospectus or documentation that would cover a potential change in the underlying reference rate. This helps to reduce uncertainty risk for a holding as this situation develops. An increasing amount of new issuance has appropriate fall-back language in it, and we believe this should increase over time.

Structured credit

Structured credit issues such as Asset Backed Securities are typically issued out of a special purpose vehicle (SPV) and backed by a pool of underlying assets. The trustee of the SPV can ask bondholders to approve a proposal to change the reference rate for coupon payment, etc. This means that even for bonds and loans based on LIBOR that do not have appropriate language to cope with a change to a reference rate, a change can still be made. Again, this would likely proceed on a case-by-case basis and depends on the outcome of the proposed replacement reference rate. Any conversion would be evaluated on its own merits and we would 'vote' on a suitable replacement when or if this is raised by the trustees of an SPV.

Loans

Insight is a member of the Loan Market Association (LMA) and is actively monitoring discussions regarding the LIBOR transition within loan markets. The LMA are building additional flexibility into current credit agreements but are awaiting feedback on draft documentation regarding the use of new benchmark risk free rates.

As you can see from the contents of this paper, Insight is an active participant in the LIBOR transition process, and we believe that we are well prepared for the coming change.

FIND OUT MORE

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