The Great Transition: The search for a libor replacement

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No one knew it at the time, but in 1969 Minos Zombanakis was soon to make history. That winter, the Greek financier had convened a group of banks in Manufacturers Hanover’s newly minted London office. His intention? To formalise the first syndicated loan of its kind to fund an US$80m loan to Iran. Given the immense scale of the loan at that time, Zombanakis aimed to reduce lender risk and increase appetite among candidate banks by apportioning the credit across several lenders, thereby generating a syndicated loan.

At the time, interest rates in the UK were 8% and rising, so most banks were reluctant to lend at a fixed rate for an extended duration. Consequently, Zombanakis devised a system whereby the borrower – in this case, Iran – could be charged a variable interest rate. He proposed that the pricing should be based on the syndicate’s weighted average cost of funding plus a spread for a predetermined period. To achieve this, the banks in the lending syndicate would report their funding costs before the loan’s “rolling over” date. Then, a computed average (and an applied margin) would be charged to the borrower for the subsequent period. This sequence led to the birth of the London Inter-Bank Offered Rate (LIBOR). The capital markets embraced this structure, and within 10 years, the syndicated loan market proliferated to around US$50bn with LIBOR as the base rate.

Eventually, other debt products began to use LIBOR; bonds were pegged to LIBOR, and it also became used for derivatives including interest rate swaps. It became the primary benchmark globally for trillions of dollars of transactions ranging from a broad spectrum of financial instruments and asset classes. From the early 1980s onwards, The British Bankers’ Association (BBA) administered the LIBOR rate-setting process. By 2005, the BBA would survey a panel of 16 banks daily, and LIBOR was calculated using only the average of the median eight quotes. The BBA produced 150 LIBOR benchmarks in 10 currencies with 15 maturities (overnight to 12 months).

Historically, only a few voiced apprehensions about the structural weaknesses of the LIBOR setting process. In time, some fundamental flaws to LIBOR’s reliability came to light. During the financial crisis, some troubled firms presented themselves as creditworthy by submitting exaggeratedly low estimates of their funding costs. Post the financial crisis, it became evident that some of the panel banks in the process were deliberately misrepresenting their estimated funding costs, in order to make a profit on their LIBOR-linked assets. In hindsight, it seems a glaring flaw to base the panel’s submissions on estimates of borrowing costs and not valid transactions. This loophole is what ultimately led to the ability to manipulate the benchmark rate quite easily.
In 2012, regulators fined several financial institutions over US$9bn for their role in manipulating LIBOR. Subsequently, in 2014, the ICE Benchmark Association (IBA) took over from BBA as the administrator of LIBOR and, since then, the IBA has produced LIBOR in five currencies with seven maturities on London business days. Further, the IBA was tasked with enhancing the rate-setting process to mitigate its weaknesses. Another structural issue with LIBOR is that it relied on the volume of interbank unsecured funding markets, which then decreased enormously. Since the debt crisis, banks have reduced their unsecured lending to each other. Also, the liquidity coverage ratio applied to banks under Basel III regulations has significantly increased the cost of short-term interbank lending. Consequently, banks are relying mostly on deposits for short-term funding.

In acknowledgment of the issues around LIBOR’s reliability, in 2013, the G20 directed the Financial Stability Board (FSB) to review systemically important interest rate benchmarks. The ensuing FSB report recommended the development and use of Risk-Free Rates alongside the enhancement of LIBOR. However, the initial objective of LIBOR reform was to address its weaknesses and to improve on the rate. In tandem, other options were considered with the view that new reference rates could co-exist as substitutes for LIBOR. The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) shared the view that in place of estimates, actual transactions should be the basis of future benchmarks. They also determined that the interbank lending market was no longer liquid, yet this continuing assumption is what underpinned the LIBOR methodology.

It was not until 2017 that the UK Financial Conduct Authority (FCA) announced the potential discontinuation of LIBOR and suddenly the benchmark’s future appeared doomed. Panel banks had been unwilling to provide quotes owing to the increased compliance costs and perhaps due to the risk of litigation, some banks had altogether stopped submitting indicative prices. Presently, the FCA has persuaded some panel banks to keep providing quotes until at least the end of 2021. The challenge is no longer to establish alternatives to exist side-by-side with LIBOR, but rather to prepare for the event that LIBOR is to cease.

Globally, regulators have reiterated that the process of phasing out LIBOR and transitioning to alternatives presents a risk to financial markets. They concede that it is essential that viable replacements are established by 2021. Due to this acknowledged risk, there is a harmonised focus on creating alternatives less prone to manipulation. Regulators in various jurisdictions are in collaboration with market participants to terminate currently used benchmarks in favour of replacements.

In the US, the Federal Reserve assembled the Alternative Reference Rates Committee (ARRC) in 2014 to plan a transition from US dollar LIBOR. They created a new rate – the Secured Overnight Financing Rate (SOFR). SOFR has been published daily since April 2018, and it measures overnight borrowings using repo transactions collateralised with US Treasury securities. Although SOFR is based on arguably the most liquid money-market instrument, it has been noted for its volatility, especially near quarter and year-end.

In the UK, the favoured alternative to sterling LIBOR is the Sterling Overnight Index Average (SONIA) which has been administered by the Bank of England since 2016. In April 2018, SONIA was enhanced to a more transaction-based approach, and it is based on the mean of interest rates paid on eligible sterling-denominated deposit transactions.

In Switzerland, the Swiss Average Rate Overnight (SARON) is the chosen replacement for the Swiss franc LIBOR. It is a reference rate based on data from the Swiss franc repo market.

In Japan, the Tokyo Overnight Average Rate (TONAR) published by the Bank of Japan, has been identified as the prime choice for a risk-free rate.

Conversely, the European Central Bank (ECB) has been lagging in efforts to establish alternative reference rates for the Eurozone. A working group assembled by the ECB nominated the short-term euro rate (ESTR). ESTR is based on wholesale euro unsecured overnight borrowing costs of banks in the Eurozone, but it is only expected to be produced by the ECB in October 2019.

Presently, the most developed alternative rate is SONIA. According to weekly published data by the International
Swaps and Derivatives Association (ISDA), as of August 2019, the US dollar notional volume of SONIA is 56% of sterling LIBOR. Conversely, equivalent SOFR volumes compared to US dollar LIBOR are less than 0.2%, while there is no volume associated with ESTR as it is yet to be launched.

The harmonised approach to replace LIBOR has so far focused on overnight substitutes because it shields borrowers from exposure to term credit risk. Some argue that using overnight rates is an opportunity to eliminate the basis risk that exists between the cash and derivatives markets. However, another school of thought is that the longer-dated cash market requires a term rate, which in turn needs a longer-dated derivatives market that only exists to hedge long-dated cash instruments.

In January 2019, IFC issued its first bond linked to a new reference rate; a three-year £500m sterling SONIA linked note which was significantly oversubscribed. Bank treasuries took up 95% of the bond’s order book, and the bond was priced at a spread of 25 basis points over daily compounded SONIA with a five-day observation lag paid quarterly. So far, most of the initial bond transactions linked to new rates have been short-dated. Longer-dated issuances are expected to come to market as expertise progresses in hedging and trading the rates. For now, the need for term rates is met by compounding in arrears over a period to result in a retrospective rate. This retrospective process is the opposite of LIBOR, which is a forward projection rate. LIBOR was created to provide a forward-looking rate as a risk mitigant to future inflation and interest rate increases. This need for a protection over future hikes still exists for lenders. Thus, an overnight compounded retrospective rate may not be best suited for the loan markets.

Despite the progress made in the creation of alternative rates, in the international markets, about US$370 trillion worth of assets are still linked to LIBOR. A subset of these assets has a duration longer than 2021, and so a repricing mechanism would need to be established for the period after LIBOR ends. It is interesting to note that although LIBOR remains widespread, it is used mostly for derivatives. In February 2019, Michael Held, the General Counsel of the Federal Reserve Bank of New York, stated that “the gross notional value of all financial products tied to US dollar LIBOR in the US is around US$200 trillion—about 10 times US GDP. That includes US$3.4 trillion of business loans, US$1.8 trillion of floating-rate notes and bonds, another US$1.8 trillion of securitisations, and US$1.3 trillion of consumer loans held by about four million individual retail consumers, including around US$1.2 trillion of residential mortgage loans. The remaining 95% of exposures are derivative contracts.”

Further illustrating the gap, ISDA data for the first quarter of 2019 showed that transactions linked to new rates accounted for less than 3% of the notional derivatives market. ISDA has been working on a protocol for the amendment of derive contracts to incorporate new rates and fall-back provisions. For exchange-traded assets, they will adopt the same basic fall-back methodologies as ISDA. Besides the uncertainty with LIBOR linked derivatives, there are many other products impacted, such as loans, floating-rate notes, and numerous other financial retail products that traditionally reference LIBOR. For lenders, perhaps a place to begin would be to identify existing LIBOR based contracts that exceed 2021. Another consideration regards future agreements and whether they should reference an alternative rate or include fall-back language to guide changes to benchmark rates. In the US, the ARRC has published recommended fall-back documentation for new floating rate notes, loans and securitisations using SOFR as the preferred alternative rate.

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The bottom line is that LIBOR may be in its dying days, and to avoid market disruption, the transition to selected replacement reference rates must be executed in an orderly and efficient manner. It is most logical that market participants desist from the current practice of executing new contracts using LIBOR. Continuing to use LIBOR seems like a head-in-the-sand approach except where there is no alternative. In such cases where there is in fact no alternative, new LIBOR contracts must have adequate fall-back provisions.

For those existing assets that extend past 2021, renegotiations and conversions to new rates should be considered ahead of the forecasted expiration date for LIBOR. In the bond markets, a precedent was recently achieved in May 2019 when the Associated British Port successfully converted their LIBOR based bond to SONIA. This was achieved following the consent from the bond investors to whom no consent fees were paid. This case was the first time in the global markets that a LIBOR linked bond was amended to a new risk-free rate, providing a model that other issuers could follow. The pricing mechanism used for the conversion could also be applied for any debt type.

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