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Libor: Is there a right time to pull the switch? And what are the risks of delay?

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29 August 2017

Financial institutions and traders can face operational risks if the switch to an alternative benchmark is delayed. A paced transition plan will be introduced for U.S. institutions. The Fed will likely ensure that institutions follow the plan and switch from Libor.

Facts

The Financial Conduct Authority (FCA) has come to an agreement with the twenty panel banks such that the banks will be obligated to submit benchmark Libor rates until the end of 2021. FCA is the financial conduct regulatory body in the United Kingdom that has regulated Libor since April 2013 through its work with the Libor administrator, the InterContinental Exchange (ICE) Benchmark Administration, and through the work of the panel banks submitting contributions to the benchmark. The Chief Executive of the FCA, Andrew Bailey, has reported[1] that the FCA has been persuading the twenty panel banks to continue submitting Libor rates to avoid financial market disruptions since the departure of one or more banks from the panel would cause the current robustness of the benchmark rate to crumble. Nevertheless, the panel banks continue to feel discomfort in submitting a rate whose underlying active market is absent and about which expert judgments are hard to verify with actual borrowing activity. While the FCA has the power to obligate panel banks to continue submitting to Libor, under the current agreement they will cease to exercise that power in 2021. The FCA offers a longer period of transition off of the Libor benchmark than the two-year period described in European Union regulations.

> "In our view it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them." Andrew Bailey, Chief Executive of the FCA, Bloomberg London, July 27, 2017

United States: On June 22nd, the Federal Reserve System (FRS) sponsored group known as the Alternative Reference Rates Committee (ARRC) voted to replace U.S. Dollar Libor with the Broad Treasuries Financing Repo rate (BTFR), which is linked to the cost of borrowing cash secured by U.S. government debt.

In an August 11, 2017 Wall Street Journal article, Jerome Powell, Board of Governors of the Federal Reserve System, and Christopher Giancarlo, chairman of the U.S. Commodity Futures Trading Commission, argued that "Of course, Libor could remain viable in some form past 2021, but market participants can't safely assume that it will. The time has come to move away from it."

The ARRC will be refining the proposed transition plans and will continue working on implementation options for the recommended rate. The intention of the Committee is to publish a final report later this year. The Committee plans to align the new rate with the other parts of the financial system and create futures and money-market derivatives along with overnight index swaps, which will depend on the suggested alternative rate.

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[1] Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London, July 27, 2017 https://www.fca.org.uk/news/speeches/the-future-of-libor

The Federal Reserve Bank of New York (FRBNY) plans to start publishing BTFR daily in the first half of 2018 in collaboration with the Office of Financial Research at the U.S. Treasury Department. Prior to publishing, the BTFR must undergo a round of public comment.

The FRS and the U.S. Commodity Futures Trading Commission are promoting a plan that will aid in the adoption of BFTR by:

- dealing with U.S. Dollar Libor-based contracts maturing after 2021
- expanding adoption of the BTFR into a wider array of products that rely on a benchmark
- allowing enough time to make the transition "cooperatively and smoothly"

United Kingdom: In April, the Risk Free Rate Working Group proposed replacing Libor with the reformed Sterling Overnight Index Average, or Sonia. Sonia is administered by the Bank of England and is based on actual overnight unsecured lending and borrowing market transactions, reflecting bank and building societies' overnight funding rates in the sterling unsecured market. Bank of England Governor Carney said in early July that Libor is no longer suitable.

Switzerland: Similarly, in November 2016, ACI Suisse, the Financial Markets Association of Switzerland announced the termination of the Tomorrow/Next Overnight Indexed Swaps (TOIS) benchmark rate by December 2017. Similar to FCA's efforts with Libor, the National Working Group on reference interest rates (NWG) made efforts to increase the robustness of the TOIS. Yet faced with a continuously decreasing size of the submitting panel and the lack of transactions underling the benchmark, the NWG found it un-sustainable. The NWG has recommended replacing TOIS with the Swiss Average Rate Overnight (SARON), an overnight interest rates average referencing the Swiss Franc interbank repo market launched by the Swiss National Bank.[2]

About the new rate –BTFR

The key features the ARRC has been looking for in the U.S. Dollar Libor alternative rate were 1) the new rate should comply with new international financial-market standards promoted by the International Organization of Securities Commissions – standardized terms, accountability, transparency of data, and availability of historical data; 2) the rate should have a benchmark quality ensuring long-term robustness, integrity, and continuity of the rate through the substantial depth of the underlying market – liquidity, transaction volume, and resilience; and 3) ease of transition to the rate in terms of the anticipated demand for it, the relevance to hedging and trading, and the potential for a term market.

The BTFR meets these standards and will reflect $660 billion in daily real transactions, rather than the hypothetical transactions reflected in the Libor rate. By its construction, the rate would be nearly impossible to manipulate. The FRBNY will produce the alternative rate that will exclude Federal Reserve transactions and will include three sources: cleared triparty data, bilateral data, and inter dealer transactions as follows:

- Data from actual transactions throughout the repo market will be included
- Data from the tri-party market, where a third party - the Bank of New York Mellon - clears transactions between two other parties, will be included
- Data from inter-dealer transactions cleared by the Depository Trust and Clearing Corporation (DTCC) will be included

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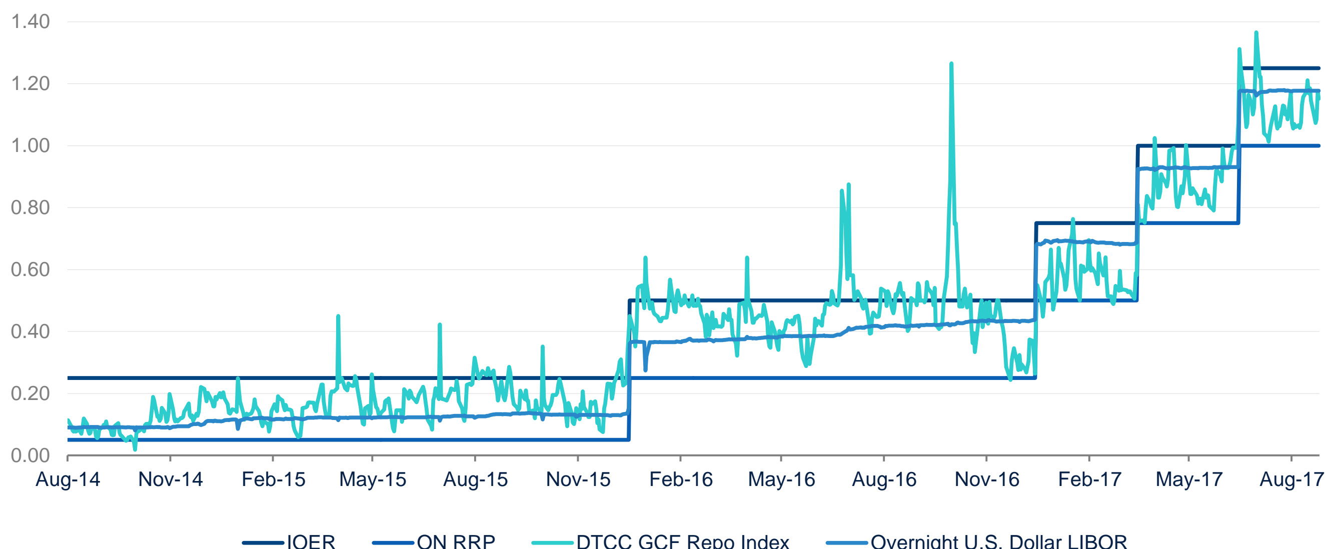
[2] National Working Group on CHF Reference Interest Rates. "Discontinuation of TOIS fixing and replacement with SARON – impact and recommendations." 22 February 2017 https://www.snb.ch/n/mmr/reference/discontinuation_20170126/source/discontinuation_20170126.n.pdf

- Some bilateral transactions will also be included
- The Fed's own repo transactions will be excluded

The FRBNY is expected to apply a conservative trimming methodology to the bilateral data to account for "special" trades. The filter will exclude the lower 25 percent of daily bilateral trades when calculating the volume-weighted median. As a result of the filter, the BTFR will be placed closer to the middle of the corridor between the Rate on Excess Reserves (IOER) and Overnight Reverse Repo (ON RRP) rates. The BTFR methodology will introduce volatility but the BTFR will be much less volatile than General Collateral Financing (GCF) rate.

Figure 1. A Comparison to Other Repo Rates (%)



Source: FRB, FRBNY, WSJ, ICE & BBVA Research

Table 1. A Comparison of the Broad Treasury Financing Rate Comparison to other Repo Rates

	Average Daily Volume	Average Daily VWM Spread to IOER	Standard Deviation of the Daily Change in the VWM spread to IOER
	$, Billions	Basis points	Basis points
Narrow General Collateral (GC) repo rate	254	-19	2
Broad General Collateral (GC) repo rate	306	-19	2
DTCC GCF Repo Index	95	-9	6
Broad Treasury Financing Rate (BTFR)	660	-15	3

Source: ARRC, FRBNY, JP Morgan, DTCC, FRBNY Staff Calculations & BBVA Research

The BTFR has to undergo a round of public comment, after which it will be published. The expected publication date for BTFR is late 2017 to early 2018.

The implementation of the transition to the alternative benchmark

The U.S. is in the midst of the second step of implementing the transition to the alternative benchmark rate – the “Set Up” phase, where the ARRC, the exchanges, and Central Clearing Counterparties (CCPs) make operational and infrastructural preparations.

Paced Transition Plan

Step 2: Set-Up

- **Requirement:** Start regular production and publication of New Rate

Step 3: Trading in New Rate futures

Step 4: Cleared New Rate Overnight Index Swaps (OIS)

- **Requirement:** Adequate New Rate history and market activity for CCPs to set margin levels for New Rate OIS

Step 5: New Rate PAI & discounting

- **Requirements:**
  - General acceptance of New Rate as alternative gauge of financing cost of settlement variation
  - Sufficient trading flows in New Rate futures/OIS to ensure valid daily marks
  - Broad acceptance of New Rate OIS term structure as alternative basis for valuation and margining

Step 6: CCPs stop accepting new swaps with effective Federal funds rate price alignment interest and discounting

- **Requirements**
- Broad consensus that New Rate represents financing cost of settlement variation
- Broad consensus that New Rate term structure is appropriate basis for valuation and margining

Source: ARRC and BBVA Research

Implementation and Risks

The U.S. and European financial regulators have implemented the first steps of offering markets an alternative to Libor. They have expressed serious doubts on the sustainability of Libor as a benchmark measure in the absence of underling active markets. The regulators have also expressed the opinion that it would be “undesirable” to continue with Libor.

Some financial strategists doubt that the new benchmark will be able to replace Libor entirely and will serve as a backup in the case of Libor market disruptions because Libor rates are very pervasive and are used in many different jurisdictions. In their current form, the new benchmarks do not yet align with the most popular maturities of one and three months. The market participants who resist the change can find alliance with ICE benchmark administrators who view BTFR and Sonia as inadequate replacements to Libor due to the lack of the range indices

across currency and maturities. ICE administrators intend to continue reporting Libor despite the risk of vast decline in the number of banks in the submitting panel after 2021. Thus, it is not guaranteed that beyond 2021 the Libor will remain in its current form – a dynamic benchmark based on daily submissions and updates.

The current actions indicate that the Federal Reserve, in cooperation with other U.S. financial regulators and the ARRC, will guide a paced transition off of the U.S. Dollar Libor benchmark. One of the possibilities is for the Fed to require financial institutions to produce feasible and robust plans for the transition of new and legacy contracts, including the event of Libor ceasing to exist. The other possibility would be to enforce the change by amending the U.S. Dollar Libor replacement protocol, giving participants a scheduled plan of transition.

While the ARRC's work on transition is at its second step, as it moves forward, there will be substantial risks for financial institutions with regard to both early and delayed transition. In the event of an early switch to the new benchmark, the institutions will carry a risk that Libor will continue to exist in its current form as a widely accepted benchmark past 2021. In the case of delayed transition, institutions could be left to carry substantial operational risks, especially if the guidance is comprehensive enough and requires attorneys to re-write legacy contracts. While authorities will assist with the transition, market participants would be left to take responsibility for individual transition plans. Additionally, a loosely guided transition can lead to uncertainty in Libor-based swap rates, tighter swap markets, and lower rates, while the size of the derivatives exposures can create systemic risks for financial markets if liquidity in Libor were to fall further.

The transition, overall, is in its early stages and the Fed will likely ensure both that the switch to the new benchmark will happen smoothly within the given 4-year window and that the U.S. market participants will follow the paced transition plan. Those participants should expect the nature of the powers to change once the alternative benchmarks are designated as a critical benchmark by the financial regulators.

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