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WHISTLING PAST THE LIBOR GRAVEYARD

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Reports of the demise of the IBORs may be premature. However, there are significant concerns about the viability of the remaining interbank offered rates (a bit of a misnomer, as discussed below) and active planning for replacement rates.

Since the LIBOR investigations and the Wheatley Review of LIBOR—Final Report (September 2012) (Wheatley Report), there have been significant changes to LIBOR. Prior to the financial crisis, there were 10 currencies and 15 maturities—a possible 150 LIBOR rates. Now, LIBOR has been cut back to the most liquid rates, with five currencies (USD, Swiss Franc, Yen, Euro and Pound Sterling) and seven maturities, resulting in a maximum of 35 rates. The other most widely used and active IBORs are EURIBOR and TIBOR (Tokyo Interbank Offered Rate).

Regulatory Recommendations for LIBOR Improvement

Prior to 2012 and the Wheatley Report, LIBOR was administered by the British Bankers Association. The Wheatley Report concluded that the existing governance and surveillance frameworks were inadequate to safeguard the integrity of LIBOR. LIBOR is now administered by ICE Benchmark Association (IBA), which is regulated by the UK Financial Conduct Authority (FCA). LIBOR reflects the rate at which large rate-submitting banks (the "Panel") indicate that they could obtain unsecured funding for a given period in a given currency.

In its 2014 Report on Reforming Major Interest Rate Benchmarks (2014 FSB Final Report), the Official Sector Steering Group (OSSG) of regulators and central banks of the Financial Stability Board (FSB) recommended strengthening LIBOR by basing the rate to the greatest extent possible on actual transaction data.[1] In response, in March 2016, IBA set out a roadmap for LIBOR improvement, which clarified LIBOR submission guidelines and established a waterfall of submissions. The IBA roadmap envisions implementation of the new waterfall of submissions during 2017.[2]

The IBA roadmap widens the set of funding centers from London to most global funding centers, widens the counterparties from interbank funding to most sources of wholesale funding (including unsecured loans by non-financial corporate customers of banks, and other central bank and non-bank financial institution counterparties), and changes the rate submissions to rates that the Panel banks can fund themselves at, instead of an offer rate.

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Consequently, the London Interbank Offered Rate is no longer tied to London, nor is it an interbank offered rate—eligible transactions now include those for which the Panel bank is the borrower. The "R" in LIBOR still makes sense, though.

The IBA roadmap established a hierarchy of submissions by the Panel banks, with actual transactions preferred:

- Level 1 (transaction based): Direct VWAP of actual transactions over the past 24 hour period (a minimum of two transactions with different counterparties for at least $10 million each required for Level 1);
- Level 2 (transaction derived): Interpolation of Level 1 submissions at other tenors on the same day or in the same tenor as previous days; and
- Expert judgment (market data based): Uses a documented methodology for basing submissions on transactions in related markets, committed quotes, indicative quotes and other market observations.[3]

Trouble in LIBOR Land

Although LIBOR (or "R"?) has spent lots of time at the IBA gym and attempted to strengthen itself, regulators and market participants are still concerned about its health. Despite the FSOC mandate that the rate be underpinned primarily by transaction based submissions, most Panel submissions are still based on expert judgment.

In its ICE LIBOR Rate Quarterly Volume Report for Q2 2017, 3-month USD LIBOR Panel submissions were approximately 37% transaction based, with the balance being expert judgment. (3-month is the most widely used USD LIBOR rate.) 3-month GBP LIBOR was approximately 25% transaction based and 1% transaction derived with the balance being expert judgment. 3-month Yen and Swiss Franc LIBOR are more problematic, have been 100% and approximately 99% expert judgment based, respectively.[4]

The FSOC, in its 2014 Annual Report, questioned LIBOR's sustainability and raised concerns about the effect of a LIBOR cessation:

> Reliance on USD LIBOR creates vulnerabilities that could pose a threat to market integrity, the safety and soundness of individual financial institutions, and to U.S. financial stability. . . . [T]he current and prospective levels of activity in unsecured interbank markets raise the risk that continued production of LIBOR might not be sustainable. The cessation of such a heavily used reference rate would pose substantial legal risks and could cause substantial disruptions to and uncertainties around the large gross flows of LIBOR-related payments and receipts between financial institutions.[5]

Current LIBOR Risks

There is no guarantee that the Panel submitting banks, currently numbering from 11-17 for the various LIBOR currencies, can be forced to submit quotes indefinitely, particularly if there are insufficient transactions to report. One bank recently dropped out of the Panel.[6]

If LIBOR were to cease publication, current market participants may be unprepared to respond.

First off, the current LIBOR fallback to be used in the event that the rate is not published, USD-LIBOR-Reference Banks (Reference Banks), is a fantasy. If LIBOR were not to be published, the 2006 ISDA Definitions require that the Reference Banks fallback be used. Reference Banks requires that the calculation agent poll financial institutions for quotes for deposits in U.S. dollars for the index maturity and, if less than two quotes are provided, to poll major banks in New York City for quotes for loans in U.S. Dollars, for the index maturity.

The chances of the calculation agent receiving a response to its request are practically nil. If LIBOR were not published, that would mean that there were no quotes available from the Panel. It is simply not plausible that a Panel bank without a transactional quote would provide such a quote in response to a phone call from a calculation agent, and therefore potentially expose itself to liability.

A very practical implication of a potential LIBOR cessation followed by a fallback failure is that many LIBOR floating rate notes would likely become fixed rate notes and also not match their hedge. The ISDA provisions, including Reference Banks, are built into countless medium-term note programs and floating rate notes linked to LIBOR. The LIBOR provisions in almost all medium-term note programs and floating rate notes also include an additional fallback in the event that Reference Banks fails, which calls for either the rate in effect for the previous period to be the rate in effect on the new interest reset date, or, in some cases, defaults to calculation agent discretion in setting the new rate. Because this last fallback is not in the ISDA definitions, if it were to be used, the affected floating rate note would not match its hedge because the swap documentation automatically incorporates by reference the ISDA definitions.

Switching to an Alternative Rate

Regulators and oversight groups have called out weaknesses in the IBOR fallback provisions. In the 2014 FSB Final Report, the OSSG stated that "[i]n most cases, fall-back provisions are not sufficiently robust for a permanent discontinuation of a key IBOR."[7] The IOSCO Principles for Financial Benchmarks, Principle 13, provides that benchmark administrators should encourage benchmark users to take steps to ensure that contracts or other financial instruments that reference a benchmark have robust fall-back provisions in the event of material changes to, or cessation of, the referenced benchmark.

In addition to strengthening the IBORs, regulators have recommended an alternative, nearly "risk-free" reference rate for each of the LIBOR currencies.[8] For USD LIBOR, the Alternative Reference Rates Committee (ARRC) selected on June 22, 2017 the "broad Treasuries repo financing rate"), a secured overnight rate, as an alternative to USD LIBOR.[9] The new rate is described as being based on transaction-level data from a tri-party repo clearing platform, data occurring within DTCC's General Collateral Financing Service and trimmed bilaterally settled Treasury repo transactions cleared by the Fixed Income Clearing Corporation. Federal Reserve transactions in the repo market would be excluded.[10] The new rate is expected to be published in the second quarter of 2018. Similarly, alternative nearly risk free rates have been identified for GBP LIBOR (Sterling Overnight Index Average (SONIA))[11] and JPY LIBOR or JBA TIBOR (the uncollateralized overnight call rate).

Existing LIBOR documentation would have to be amended to include the broad Treasuries repo financing rate as a fallback rate IF LIBOR ceases publication. Switching to a new rate would require a spread to adjust between the two rates, and ISDA has identified issues surrounding creating a spread, such as the methodology for calculating the spread, the sources of inputs for calculation of the spread, the entity to calculate the spread and the entity to publish the spread. Changing from LIBOR to the broad Treasuries repo financing rate would also require the market to adjust from a forward-looking unsecured rate to a backward-looking secured rate.

Conclusion

Despite efforts to improve the IBORs in response to the Wheatley Report and other regulatory reports, there is a strong possibility that LIBOR may be replaced by an alternative nearly risk-free rate, in the case of USD LIBOR, the broad Treasuries repo financing rate. Although ISDA's work on the transition is not complete, market participants should keep this possibility in mind when planning transactions.

ENDNOTES:

[1]*See* the Financial Stability Board "Reforming Major Interest Rate Benchmarks" (July 22, 2014) at 2, available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf.

[2]The IBA Roadmap for ICE LIBOR (Mar. 18, 2016) is available at: https://www.theice.com/publicdocs/ICE_LIBOR_Roadmap0316.pdf.

[3]Efforts are being made to strengthen the other IBORs, such as EURIBOR, TIBOR and others, which are beyond the scope of this article.

[4]The ICE LIBOR Quarterly Volume Reports are available at: https://www.theice.com/iba/historical-data.

[5] FSOC 2014 Annual Report at Section 7.14.

[6]*See* Bloomberg (Oct. 5, 2016)*BNP Paribas Quit USD Libor Panel; Leaves Committee w/17 Members*.

[7]*See* Market Participants Group on Reforming Interest Rate Benchmarks Final Report (March 2014) at 12, available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf.

[8]*See* the 2014 FSB Final Report at 2 ("Members believe that there are certain financial transactions, including many derivatives transactions, that are better suited to reference rates that are closer to risk-free.")

[9]*See* "The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate" at: https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf. The ARRC was convened in November 2014 by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York. It consists of 15 voting financial institutions, five non-voting members, including clearing entities and ISDA, and five ex-officio members, all federal regulators.

[10]*See* Federal Reserve Bank of New York, "Statement Regarding the Publication of Overnight Treasury Repo Rates" (May 24, 2017) at: https://www.newyorkfed.org/markets/opolicy/operating_policy_170524a and Kathryn Bayeux, Alyssa Cambron, Marco Cipriani, Adam Copeland, Scott Sherman, and Brett Solimine, "Introducing the Revised Broad Treasuries Financing Rate," Federal Reserve Bank of New York *Liberty Street Economics* (blog), June 19, 2017, http://libertystreeteconomics.newyorkfed.org/2017/06/introducing-the-revised-broad-treasuries-financing-rate.html. "Trimmed" means that the Federal Reserve Bank of New York intends to remove all bilateral transactions with rates below the 25th volume-weighted percentile rate from the rate calculation each day.*See Liberty Street Economics* (blog), June 19, 2017.

[11]*See* Bank of England News Release "SONIA recommended as the sterling near risk-free interest rate benchmark" (Apr. 28, 2017) at: http://www.bankofengland.co.uk/publications/Pages/news/2017/033.aspx.